S. HRG. 103–1029

U.S. PRIVATE SAVINGS CRISIS—LONG-TERM ECONOMIC IMPLICATIONS AND OPTIONS FOR REFORM

Y 4. F 49: S. HRG. 103-1029

U.S. Private Savings Crisis-Long-Te...

HEARING

BEFORE THE

SUBCOMMITTEE ON DEFICITS,
DEBT MANAGEMENT
AND LONG-TERM ECONOMIC GROWTH

OF THE

COMMITTEE ON FINANCE
UNITED STATES SENATE

ONE HUNDRED THIRD CONGRESS

SECOND SESSION

DECEMBER 7, 1994

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U.S. PRIVATE SAVINGS CRISIS—LONG-TERM ECONOMIC IMPLICATIONS AND OPTIONS FOR REFORM

WEDNESDAY, DECEMBER 7, 1994

U.S. SENATE,
SUBCOMMITTEE ON DEFICITS, DEBT MANAGEMENT AND LONG-TERM ECONOMIC GROWTH,
COMMITTEE ON FINANCE,
Washington, DC.

The hearing was convened, pursuant to notice, at 9:13 a.m., in room SD–215, Dirksen Senate Office Building, Hon. Bill Bradley, Chairman of the subcommittee, presiding.

Also present: Senator Packwood.

OPENING STATEMENT OF HON. BILL BRADLEY, A U.S. SENATOR FROM NEW JERSEY, CHAIRMAN OF THE SUBCOMMITTEE

Senator BRADLEY. The subcommittee will come to order. I would like to welcome all of our panelists and guests today to the subcommittee. This is the second hearing that the subcommittee has held on the issue of savings and retirement security.

Last June, we met to determine whether the United States was facing a savings crisis. At that time, we noted that the national savings rate had fallen from an average of 7.7 percent of gross national product in the 35 years up to 1980, to 3.0 percent between 1981 and 1993, and to less than 2.0 percent in 1993.

Given the threat that this decline poses for future economic growth and for retirement security, we concluded that we were, indeed, facing a serious savings crisis in this country.

I called today's hearing in order to focus our attention on the consequences of this crisis and to open a dialogue that hopefully would lead to solutions to the crisis. In order to solve it, we need to attack both the decline in private savings rates, which went from about 8.6 percent to 7.5 percent, or 6.8 percent, and the explosion of public DIS savings, which is the explosion of debt from $750 billion to $4.5 trillion in little more than 12 years.

For today, however, I hope that we can focus on the decline on private savings and the threat it poses to the ability of individuals to live comfortably in their retirement. Unfortunately, all too often we discuss matters of public urgency without acknowledging the human face associated with each issue.

I believe it is vital that the debate illuminate the real world, and I am very pleased that we have a number of witnesses today who

will give us personal testimony about the effect of the savings crisis on their own lives.

Although we know that as a nation our private savings rates lagged behind those of our main competitors, what does this mean for the young New Jersey family that is struggling to make ends meet, let alone to set aside a little for a rainy day? How about the older divorced woman whose only savings come out of her small paycheck as a part-time worker?

What do declining private savings rates mean for the construction worker who is forced to move from job to job in order to find steady work and, as a consequence, never finds one job long enough to vest any pension right?

Finally, what does it mean for the harried computer consultant fortunate enough to participate in her employer's defined contribution plan but faced with the daunting and time consuming responsibility of investing those funds for her retirement?

Each of us, younger, middle aged, and older Americans, has to deal with the constant struggle between satisfying today's wants and tomorrow's needs. Should you buy new school clothes for your children or set the money aside for college education? Should you buy a computer or save for the down payment on your first house? Unfortunately, with the decade long drop in real wages, this struggle becomes all the more difficult.

Should you borrow against your retirement plan to pay the mortgage and risk losing your home? In this struggle, long-term goals frequently lose out to short-term needs. Too often, the cumulative effect of these tradeoffs leaves individuals facing retirement with little or no savings. In a 1989 study, the Social Security Administration stated that the median personal savings of retired workers was less than $10,000, excluding home and car. Therefore, unless these individuals plan to sell their homes, they will have very little to live on, other than their Social Security benefits.

Unfortunately, given the rise in property taxes and other household expenses, many of these individuals will be forced to sell their home simply because they will no longer be able to afford to live in the home.

The risk that individuals will not be able to maintain their living standard as they age is not limited only to those who are already retired. In one recent study, it was estimated that individuals aged 35–44 were accumulating assets at only one-third of the rate necessary to maintain their living standard in retirement. They were saving only one-third what they need to save in order to have enough to maintain their living standard in retirement.

As a result, this group of baby boomers, the ones 35—42, will have to either significantly increase their savings rate or suffer lower standards of living as they age. Unfortunately, even when individuals are among the lucky few with substantial retirement savings, they often lack the time and the financial expertise to properly manage those savings for the long-term. So, decline in private savings presents us, as a Nation, as individuals, with enormous challenges.

The cost of failing to meet these challenges mounts with each passing day, and I hope that today's hearing will help us meet

these challenges in a way that satisfies our individual retirement needs and our National economic objectives.

I hope, as a result of today's hearing, that more and more people will get an understanding of what is the nature of this savings crisis, and what each of us can do about it.

[The prepared statement of Senator Bradley appears in the appendix.]

Senator BRADLEY. Senator Packwood?

OPENING STATEMENT OF HON. BOB PACKWOOD, A U.S. SENATOR FROM OREGON

Senator PACKWOOD. Senator Bradley, thank you for having this hearing. There is, I think—and I say, I think, because I am not as sure of things as I used to be a quarter of a century ago when I came to the Senate—there is agreement that we need to save more and consume less. You hear this all the time. Invest and save, invest and save, and do not consume as much. We are a consumption driven economy.

If we shift to investment and savings, what is the effect? Do we have a downturn for a period of time that we must accept to invest for the long-term? I do not know. Are there many groups that would be opposed to tilting that way? I do not know. I do not know how the retailers feel, or auto dealers feel, that are basically consumption-based. These are legitimate questions.

But do we need—and I think we do—to move toward a savings and investment economy? During the 1950's and 1960's, our savings rate—I am doing this from memory, now— was never much more than about 7.0 percent. It is high by our present standards, but it was not high by European or Japanese standards.

Yet, we look back upon the 1950's and 1960's as a boom period; productivity up, real wages up, relatively modest savings. I think we reached a high of savings of around 9.0 percent in 1971, 1972, 1973, and it has trailed off since then. If we were able to move and boom with a 7.0 percent savings rate, would it be satisfactory if we got back to that now? Would we move again?

We have taken some steps toward attempting to discourage consumption. We did a bill in 1986. We got rid of consumer interest and we did not even have much objection from the auto companies or others, and it seems to have worked fine. We did foresee one thing in 1986 that could happen and did; that was the home equity loan.

We wondered what would happen if people could go out and in essence borrow on their homes for things they used to borrow personally for and deduct the interest. Indeed, that is what has happened with home equity loans. Do we want to put a cap on that?

Assuming we want to move toward more savings, what will do it? In 1981, we opened up the IRAs unlimited. For $2,000, everybody could have one. In 1982 through 1986 the savings rate went down each year after we passed the IRAs. We had conflicting evidence. Some people said, well, they just did not have time to really get going. They would start to go after four or 5 years of experience. Other evidence indicated people just shifted savings from accounts that were not tax deferred to accounts that were. No in-

crease in savings, they just smartly realized they could get a better tax deal if they put it in an IRA.

If we want to move toward savings—and I think this is the critical question, savings and investment—we make the philosophical decision. What is the best method of doing it? Senator Bradley and I have talked long and worked long on this. It seems to me there is one or two ways you can go.

You can attempt to do, as Bill and I did in 1986, and simply move the tax rates downward. I do not say the taxes downward, the tax rates downward. You get rid of the deductions and incentives we have in the code now and move as close as you decently can to a flat tax and say, investment will follow. I have run the figures. We could do a 12 percent flat tax and raise as much money as we do from the personal income tax code now. But I mean flat: no deductions for homes, no deductions for children, no deductions for charity, no deductions for anything.

So, the widow with two children and $10,000 income who now pays nothing would pay $1,200. I do not think that would be acceptable. A 12 percent flat tax, as a rule of thumb, means that everybody who makes over $70,000 a year would pay less taxes and everybody who makes under that would pay more.

But you, indeed, would have a neutral code. It would not tilt toward any kind of investment. I think, realistically, if you wanted to go to a flat tax, you would have to build into it—and Representative Armey has suggested this, I just am not sure his figures are quite square—some deductions that exempt lower income people. You have got to keep, roughly, the same progressivity we have now.

You could do it with a flat rate if you had sufficient deductions for children, basically for food, shelter, and family. You could do it. My guess is—and I have not got figures on this—you would have to be around 20, 21, 22 percent level with these built-in deductions to keep it progressive. Would that be low enough that people would say, fine, with that rate I am willing to pay it and I will still save and invest?

The other alternative, if you do not go that way, is to build into the code what you think or we think are the proper investments that save, and we have to tilt the Tax Code in that direction. And many people say capital gains and IRAs, and kind of wipe their hands and say, that is it, that will cause us to invest and save. Maybe it will, maybe it will not.

So I would say the first question we want to ask is, do we want to move from consumption—and, indeed, the code is consumption-oriented—to savings and investment? If the answer to that is, no, then we do not have to tinker too much.

If the answer to that is, yes, then we need to say, what is the best way to achieve that end? And I would hope that we do not rush pell mell into what we think will achieve that end if, indeed, there is a better way to do it.

I thank the Chair.

Senator BRADLEY. Thank you very much, Senator Packwood. I assume this will be the last hearing that you will participate in that you will not have this word beneath your name, and I am very comfortable with you as the Chair, and I will be glad to move over

and contribute as I have when you were in the Chair before. Thank you very much.

Senator PACKWOOD. Well, I might say, the day after the election, Senator Bradley was the first Senator I called. I said I was looking forward to the same relationship we had had before, and I think we are going to have that.

Senator BRADLEY. Well, with that note in the record, we are very fortunate to have as our first witness the distinguished Labor Secretary, Bob Reich. Welcome, Mr. Secretary, to the subcommittee. We look forward to your testimony. The floor is yours.

STATEMENT OF HON. ROBERT B. REICH, SECRETARY, U.S. DEPARTMENT OF LABOR

Secretary REICH. Thank you very much, Mr. Chairman, and Senator Packwood. I want to compliment you for having these hearings and for investigating this issue. I cannot think of many issues that are more important than questions, not only of aggregate savings, but there is a related question that I am going to be stressing today, and that is individual savings and the preparation of people for their individual retirements. There is an overlap between the two questions of aggregate and personal. They are not exactly the same issues, and I am going to be stressing the second.

Also, I beg your forgiveness. I have to apologize that I have got to be running off for a meeting with my boss that is scheduled, unfortunately, very soon after this. But I would be delighted to take your questions, if necessary, by writing, and get back to you very, very quickly with my answers.

Senator BRADLEY. Well, we are just very grateful that you could appear today.

Secretary REICH. Thank you.

As the members of this committee, you have devoted considerable time and attention to this issue already and

I want to congratulate you. Many of you were instrumental in passing into law last week a bill to shore up the pension system, the Pension Benefit Guaranty Corporation, and I thank you for that. I also applaud your broad commitment to retirement security. I think that is going to be going a great way to help shore up an under-funded plan and also make sure that eight million American workers get the full pension that was promised to them.

Now, whether somebody is retired or somebody is in the work force, it is not easy to be middle class these days. The primary point I want to stress this morning—and, Senator Packwood, this may have something to do with the question you raised, why is it that if you have IRAs and you went down that path with regard to IRAs, you still did not get an increase in savings?

There is an underlying trend here that must be examined, and that is the erosion of wages, erosion of compensation for a large portion of the American work force over the past 15 years. If your compensation, if your income, if your wages are eroding, it is harder and harder for you to save.

Senator PACKWOOD. I might just add there, we found when we did the IRAs, by and large, the IRAs were not a device that anybody making less than $25,000–30,000 used. They did not have any money. They could not put aside $2,000.

Secretary REICH. Well, that is precisely the point. And I think it is useful to contrast the era we have been in over the past 15 years with the era before the past 15 years. If you look at the period of time from 1945 to approximately 1975, you had an era of enormous growth and everyone shared in that growth.

We tend to look at it, perhaps, with too rosy colored glasses. It was not an era in which you have quite the degree of equal opportunity, but at least poverty rates were falling, a lot of the barriers to equal opportunity for many people in the society were falling, and average wages were going up, even average hourly wages were going up, median wages were going up.

This Nation turned our hard work into homes, and health care, and pensions, and cars. We did, in fact, invent the postwar middle class in those years, and that is a middle class that sustained us. It sustained our savings and retirement.

But then something happened, and a very dramatic thing happened. Beginning in the late 1970's and continuing with the last 15 years through recoveries and recessions, and recoveries and recessions, something very profound happened to American wages. American wages began to stagnate.

Indeed, adjusted for inflation, hourly wage earners began witnessing a significant drop in their incomes. Labor unions, once a middle class staple, declined. A global economy made competition more fierce, jobs less certain.

But, most importantly—and I want to stress this—it was new technologies, especially computerized technologies, revolutionizing the workplace that drove a wedge between those people who were best prepared to deal with those technologies and those who were not.

The old middle class, which was founded on mass production, those big $10 to $24 per hour jobs which you could get with only a high school degree began evaporating, disappearing.

As the economy changed, middle class families tried every means of holding on. We saw a lot of coping mechanisms being used. Spouses went to work. In the 1970's a lot of spouses went into the work force. I wish I could say women went into the work force because of these wonderful new opportunities for women in the 1970's and 1980's. Well, there was some of that.

But the primary reason that women went into the work force is to prop up family incomes, to maintain family incomes, because male wages started to decline. Both parents subsequently worked longer hours, they took multiple jobs, they decided to have fewer kids and have them later, they drew down their savings, all of these coping mechanisms, in order to maintain household income at the same inflationary adjusted rate it had been before.

But, unfortunately, many middle class families have pushed these coping mechanisms about as far as they can be pushed. Now, the good economic news of late is, indeed, good economic news. We ought to be very thankful for it. There are 5.2 new million jobs over the last 22 months.

I have referred to a "Goldilocks Recovery," in the sense that it is not too hot, we do not see any sign of accelerating inflation on the horizon; not too cold, we do not see any sign of cooling off in terms of wage growth. It is a good, solid recovery. Productivity is

up. This morning we learned the annualized rate of productivity, 2.9 percent rate of annualized increase. Very, very healthy, now. Profits are up.

But let me bring your attention to the fact that wages are not up. Labor unit costs are stagnating, actually. Hourly wages are down; last month we saw a two-cent decline. That is a continuation, to some extent, of the pattern that I have been sketching for you.

Last year, in the thick of a recovery, median household income continued to fall. That is, half of all American families experienced a decline in incomes, adjusted for inflation. And for workers with less education and training, the downward slide has been sharp over the last 15 years. Men without college degrees—and that is a group that includes nearly three out of four working men—have suffered a 12 percent decline in average real incomes since 1979. You try to save when your incomes are going down, when household incomes are barely holding on, that is a very difficult thing to do.

Income and earnings tell only part of the story. Now, traditionally, membership in the American middle class included not just a job with a steady increase in income, but also a bundle of benefits that came with employment. And, once again, we see a widening gap with the middle class struggling. A lot of hourly workers, average working families, struggling to make do as benefits also begin to decrease. Employer-sponsored health plans for workers with college degrees declined only slightly from 1979 to 1993, from 79 percent to 76 percent, but those are with college degrees. If you look at workers with high school degrees only, the rates have fallen further with regard to employer-sponsored health care plans, from 68 percent in 1979, to 60 percent in 1993.

If you look at high school dropouts, you see a very precipitous decline from an already low of 52 percent in 1979, to only 36 percent last year. A tremendous decline in employer-sponsored health care, again, depending and correlated increasingly with education, and pensions have followed a very similar route.

Consider: nearly two out of every three workers with college degrees gets pension coverage on the job. But then consider the other end of the education spectrum. More than three out of four high school dropouts do not get any pension coverage on the job.

Indeed, our very notion of retirement is transforming. When we think of retirement, many of us picture a worker who is rewarded for a lifetime of service with a gold watch, fond farewells, and a lifetime monthly pension check in addition to Social Security, supplemented by some carefully nurtured personal savings, perhaps in the form of life insurance. These sources of income assured, to some extent, for middle income people, a retirement of some degree of security.

But secure retirement, like middle class prosperity, although possible, it is not by any means a certainty any longer. To be sure, in the 20 years since Congress enacted ERISA, we have made great progress in ensuring that more Americans have adequate coverage and adequate incomes in retirement.

Today—and it is a big success story, I have got to tell you—more than 50 million people are earning or receiving employer-provided

benefits. The aggregate amount of savings held in our private sector pension plans—and again, I am now talking about aggregates. A moment ago I was talking about individuals, and I want to go back to individuals.

Aggregate is a pretty good story. The aggregate savings in our private sector pension plans for workers' retirement has risen more than ten-fold since ERISA became law, from less than $300 billion in 1975, to an estimated $3 trillion today.

But let us go back from the aggregates to the individuals. We still have a long way to go. About 45 percent of all current workers participate in a private pension plan, 55 percent do not. Despite the sharp growth in aggregate savings that I just told you about, that average rate, 45 percent, has not changed very much at all over the past 10 years.

Let me stress another point. Averages sometimes obscure very important details. After all, Senator Bradley, you and I have an average height of 51910". There are important details that are left out of that average. While the overall rate of coverage has been stable, the composition of coverage has changed.

As some of the barriers to better work for women in the workplace have fallen over the past 15 years, pension coverage for women has actually expanded and you would not find that surprising. Particularly the big success over the past 15 years, is in women with college degrees. Their wages have gone up, their pensions have gone up. In 1979, 40 percent of America's full-time working women received pension coverage on the job. By 1993, the figure had climbed to 48 percent.

By contrast, many men have had a much rougher time in the new economy, and that also shows up in the pension data. 55 percent of full-time working men were covered in 1979; only 51 percent were covered in 1993.

And, in general, I want to stress again the correlation between income, benefits, and education. In general, those who participate in private pension plans tend to be higher income, full-time workers at large firms, with better educations.

Only about 17 percent of workers in businesses with fewer than 25 employees are earning any pension benefits at all, and coverage of part-time workers is virtually non— existent. Contingent workers. We are seeing a great growth in contingent and part-time work that are not getting pension coverage.

Now, there has been another change, too, one with very broad implications for middle class families. When ERISA was enacted, 9 out of every 10 workers who had pension coverage at work participated in what are called Defined Benefit Plans.

Now, these traditional pension plans guaranteed, as you know, a monthly retirement check for life, with the amount of the check based on a predetermined, mutually understood formula, typically tied to salary and years of service. Now, added security for these pensions came from the guarantee provided by the Pension Benefit Guaranty Corporation, which the Secretary of Labor Chairs.

Again, I want to thank you and congratulate you for participating in that pension reform. I think those workers are much, much safer today than they were before that reform was enacted.

But bear in mind, today only about 60 percent of all plan participants are covered by this kind of plan, this defined benefit plan. While large companies are not precipitously dropping defined benefit coverage, workers who previously had no pension coverage and workers who want to supplement their defined benefit coverage are fueling a large shift to what are called Defined Contribution Plans. In these arrangements, the individual worker must contribute money to the plan and then bear the risk of how the money is invested.

Now, of course, these plans offer some advantages over the defined benefit form of pension. Defined contribution plans allow individuals to tailor their pension needs and how much money to save from each paycheck. They make it easier for today's very mobile employees to move from job to job and have pension coverage. 24 percent of all workers now save for retirement through salary reduction plans at work, up from 15 percent in 1988. This is all good news in terms of mobility, portability, and flexibility.

But, on the other hand, these plans offer no guarantee as to the amount of the pension at retirement, nor do they guarantee a monthly income for life. All they do is they promise that a participating worker will receive whatever has accumulated in his or her pension account at the time of retirement. They require that the worker correctly anticipate savings requirements and investment returns over a lifetime, no small task even for the financially sophisticated.

And there is nothing to prevent a worker from consuming his or her savings after leaving a job and receiving a lump sum distribution, an event that occurs very, very often. Workers, as you know, moving from job to job, the average worker has seven or eight jobs in a lifetime.

And, again, put that together with what I was saying at the beginning of my testimony. You have got workers, a huge number of workers today, barely holding on with regard to family income. They are dissaving. They are dipping into their savings, they are actually going into debt.

And, when you have these kinds of defined benefit plans, that is one place where they get additional money to prop up family income. An increasing number of current pension plan participants rely exclusively on defined contribution plans as their only form of employer-provided pension plans, if they have it at all.

Now, add to all this the fact that Americans are enjoying longer life expectancies and, therefore, longer retirements than Americans of previous generations, today's workers will need unprecedented levels of savings to maintain their living standards during their retirement years. But, since many workers are now earning less and saving less, obviously they will have less to retire on, especially if retirement itself grows longer.

The retirement system is shifting more responsibility to savings; in other words, to workers at the very time workers are struggling to maintain their incomes and hold onto their jobs. That is the set of interrelationships that needs to be examined.

As wages stagnate or decline, it becomes more difficult to pay this month's bills, let alone to save money for the next century. If you have a choice between paying this month's bills or saving

money for the next century, you are going to pay this month's bills. What is more, many men in their prime working years, their 40's and their 50's, today, are working less or they are dropping out of the work force altogether. Many of them are left without a pension and without the means to generate any personal savings.

Now, there is a theory, and you will hear this theory today, that as the baby boomers reach their late 40's, when they can see in the distance retirement looming, they will start saving much more. But, if my analysis holds true, the underlying structure of the economy may not give them the opportunity to do that much more saving.

Now, at the Labor Department we have encountered far too many cases of ordinary people who live regular lives, who have reached the age of 65, and found themselves unprepared.

I have read a lot of their letters, I have talked to a lot of these people, who are average workers who tried to prepare, thought they were preparing for retirement, but actually found that they were not prepared at all.

Let me describe one person. I will call him Joe. Now, Joe came to us earlier this year because he thought somewhere along the line he must have been cheated. He played by all the rules, he worked hard. But then he got to retirement and he did not have enough. All his life he had been looking forward to the day, 2 years ago, when he could retire, and then it came. Here he was at the age of 67, working part-time at a local fast food restaurant, arriving at 6:00 o'clock in the morning, he said, to prepare breakfast for bleary-eyed patrons. Where is the retirement?

Joe had worked nearly every business day of his life since finishing high school. He had held many good jobs, especially as he got older. But his employer in the early years did not provide a pension. Not that Joe, in those years, was very much concerned about it in his younger days.

Later, he held a union job as a truck driver. That did offer a good pension, but he lost all rights to any benefits when he left his trucking job without the pension having vested, another issue we did not talk about, but it is an issue for many workers.

Now, Joe's second child had just been born. He decided to take a 9:00 to 5:00 job that would keep him in town. In the 1970's, Joe finally did earn vested rights with his employer's defined benefit plan. But, in the early 1980's, his employer changed to a 401(k) style plan. Now, Joe remembers something about his company changing his pension plan, but he wasn't sure about the details at the time. It sort of happened. He got a notice. Fine. In any event, his children were in college and looking to him for support. So, when his company sent him a form asking if he wanted to forego some of his salary and have it placed in a savings plan, he declined. He needed that salary to make sure he had the payments for his kids. Paying the bills and raising a family was hard enough for Joe. So, when Joe left his job at the age of 65, he was making $38,000 a year.

Now, Mr. Chairman, Senator Packwood, members of the panel, let us remind ourselves, median family income—this is just Joe at $38,000 a year—in this country is around $34,000–$38,000 a year.

Half of all families are earning less than what Joe is making, $38,000 a year, when he is retiring.

Today, he and his wife, who never worked outside the home, receive just over $13,000 a year from Social Security. He also gets $108 each month from the defined benefit plan that he vested during the 1970's. The check is not indexed to inflation.

On that income, they cannot live, even by the modest means to which they were accustomed, and that is why Joe has to unretire and that is why, at 6:00 o'clock in the morning, Joe finds himself in the fast food kitchen at the age of 67, and that is why he is probably going to stay there.

Now, Joe's story is not atypical. If you follow my argument, I am suggesting that it is becoming more and more typical. What can be done to make retirement work and work out right for middle class Americans like Joe and Joe's family? First, obviously, we need to make sure that all Americans benefit from a growing economy. Higher wages, higher living standards, generated by a world-class work force. We need to invest public, and especially private, in our workers' skills, their abilities, their capacity to work together.

This is not simply a matter of creating jobs. The economy has added more than five million jobs since January of 1993, most in high-paying occupations. The Administration is justifiably proud of this record. But the 110 million existing jobs are splitting between a few that are paying very good wages—managerial, professional, technical—and a lot that are paying less and less, worse wages, worse benefits, and also are less secure. This is not a matter simply of generating growth. Corporate profits soared 45 percent in the last quarter. As I said, productivity, we learned this morning, rose at an annual rate in the last quarter of 2.9 percent. The economy is doing well, things are growing, companies are profiting. But wage growth has not matched this pace. This is not simply a matter of increasing overall wealth. Between 1983 and 1989—these are the last data we have from the Federal Reserve. The data up to 1992 and 1993 they have, but they have not analyzed yet—mean household wealth increased 23 percent. Average household wealth increased 23 percent, but almost all the growth went to the top 20 percent of households and half of the growth went to the upper one— half of 1 percent.

In other words, the rich got richer, the very rich got very richer, the rest of the country either treaded water or sank further, and the trend continues today. This is not a matter of class warfare. This is not criticizing anybody. The rich are entitled to the money they got.

The point is, if we are going to create a society in which the middle class can participate in the growth, they have got to have the skills, they have got to have the abilities, they have got to have the education. We have got to have workplaces that genuinely push responsibility downward to front line workers, and make them partners.

The only enduring solution is to equip every American to succeed through hard work under the rules of the new economy. The rules have changed. It used to be, you just keep your shoulder to the wheel, you will do well. The rules have changed. People have got to get the skills.

In the end, the best strategy for increasing savings is to increase wages so the people have something left to save after they have paid the rent, purchased the groceries, bought the kids' clothes, and taken care of the health bills.

Sometimes we talk about savings too much, I think, in the stern tones of a finger-wagging schoolmaster, you have to save more. We have got to realize that a lot of people cannot save. You cannot save what you do not have.

A growing economy that brings every American along must be an essential element. I am not saying it is the whole element, but it must be an essential element of our saving strategy. And, second, obviously, we need to educate Americans about the importance of taking personal responsibility for their retirement security.

Equipping workers with the financial capacity to generate retirement savings will not be sufficient if they do not grasp the fundamental importance of following that course. They need to be educated. The data demonstrate that workers do not have the right knowledge to ensure sound retirement income.

My little example of Joe, which is very typical, Joe did not get the information. Every step along the way, Joe did not know what was happening. That is vitally important. That is the second ingredient. In other words, you give people, at the very minimum, the skills and the wages to save, and, second, you give them the information so they can make wise decisions with regard to savings.

That is why, in the coming months, the Labor Department is going to be undertaking a national pension education program aimed at drawing the attention of the American workers to the importance of taking personal responsibility for their retirement security, giving them the information—people like Joe—they need to make good decisions.

Let me just conclude, Mr. Chairman, Senator Packwood. As I have traveled around the country, I have run into more and more average American workers who have told me that saving for retirement is an intimidating task. It is filled with unfamiliar, confusing concepts. They do not get it. They do not understand it. Many Americans make few or limited provisions for their retirement security during their working years.

Many of these workers, perhaps, have unrealistic expectations of what they can expect from Social Security, or they were never alerted to the need to save for retirement until it was too late. And even though these workers who have made some crucial decisions to begin savings, they still do not have the information they need.

Again, I want to stress, this is not the whole aggregate savings problem. That is a big problem. This is a piece of the aggregate savings problem that affects millions and millions of individuals. It is a big problem, it is a growing problem. I will tell you, speaking as an aging baby boomer who is going to hit retirement, maybe, if I am lucky, within the next 12, 15, 20 years, on a personal note, I will say that even people who have been as fortunate as I do not understand the retirement system. Even people as fortunate as I who have been saving some do not understand, really, the retirement system. They have not spent the time thinking about the retirement system.

Again, I want to thank you for the service that you are performing, the dedication both of you have put in, and this committee has put in, to this issue over the years. I trust and hope that, under your leadership, Senator Packwood, this good work will continue. Thank you.

Senator BRADLEY. Thank you very much, Secretary Reich. I know you have to go. Do you have time for one or two questions, just briefly?

Secretary REICH. Yes.

Senator BRADLEY. All right. Only one. It relates to the point you made about the public not being aware. I mean, it is kind of a common sense notion we are taught early in life, you have got to save in order to have it for a rainy day, or for retirement.

But more and more Americans do not understand how you save a little bit for a long time, and compound interest actually is a tremendous advantage. And they wake up like Joe, or like somebody else, thinking somebody else is taking care of me and somebody else will provide for my retirement, or they wake up too late, not having the advantage of compound interest, and without the education and information they need.

There is one OECD study that took a look at household savings and pensions, and basically concluded that what was important was the information, not the tax incentive. That when someone announces, for example, a new tax-favored savings vehicle, that this study concluded that it was the announcement and the attention to the issue of savings that drove the savings as much as the tax benefit.

So, my question to you is, what effect do you anticipate that the department's education program will have on contributions to savings?

Secretary REICH. I am hopeful, Mr. Chairman, that we can make a little bit of inroad with regard to people understanding the importance of saving, the possibilities for savings, particularly young people. I think you put your finger on it. Many young people say, well, I do not have to worry about my retirement. I mean, that is 20, 30, 40 years off. That is the last thing I have to worry about.

But, with regard to compounded interest, they do not understand if they put a little aside now they can make a lot later. I think an education program is good, but it cannot be only a government education program, obviously. I think we have got to talk much more broadly about a kind of education program in which the private sector, banks, and other savings institutions can involve themselves in to educate all Americans about savings.

I do think that merely pointing it out could have a positive effect, but let me again stress that there are so many Americans who cannot save, that we must not simply assume that by educating them we are going to see an increase in personal savings.

Senator BRADLEY. Senator Packwood?

Senator PACKWOOD. One question. On page five you say, "In the end, the best strategy for increasing savings is to increase wages." How?

Secretary REICH. Senator, I believe that the best way to increase wages in this country—and I am talking now about the middle class that is being hollowed out before our very eyes over the past

15 years—as I have said, you have got more and more people who are struggling, working longer, having smaller families, dipping into their savings, dissaving.

How do you make an economy function in which the lower middle class, working class people, and under class people can get into the middle class and participate in economic growth? I believe that education and job training are part of the answer, a very major part of the answer, because the big wage premium we are seeing, the big gap that is growing between people at the top and people at the bottom, is directly correlated with education and training. That is not all of it, but it is a big piece of it.

Senator PACKWOOD. And you are convinced that, given adequate education, the higher paying jobs are there for this great group in the middle class who are gradually being more under-educated?

Secretary REICH. I am convinced that there is no limit to the ingenuity of the human mind, that there is no fixed number of good jobs. I have traveled around this country and I have seen people, even without a college degree, with additional training, who are upgrading their skills. I have seen truck drivers with modems, faxes, and computers in their cabins and they are timing deliveries, just in time deliveries, to when their customers need it. They are helping the customers assemble complicated materials. I have seen check-out clerks who actually are inventory control specialists because they have a computer there at the check out and they are making orders and reorders, and exercising judgment. I have seen factory workers who do numerically-controlled machine tool work now. They are engineers. I have been a mile underground in a coal mine and I have seen coal miners without picks and shovels.

They are technicians, complicated technicians, working on the most complicated pieces of machinery. They are going back and forth on the seam of the coal. I cannot tell you how many examples of ordinary Americans without college degrees who are making good money, but, unfortunately, they are the exceptions to the rule. They have got training, they have got education, but most Americans do not have it in the middle class. They are without college degrees, I am talking about. Remember, 75 percent of Americans in the work force do not have college degrees, and they are sinking.

Now, let me stress, education and training is not the whole answer. I think our workplaces do have to be reorganized in a way that workers are genuine partners, and I believe that is good for the bottom line. Companies that are reorganizing work places, pushing responsibility downward, are actually doing better, with higher productivity, because those front line workers know how to improve, how to innovate. They understand the technologies and the customers almost better than anybody else.

Senator PACKWOOD. I have seen the same thing. One of our principle industries in Oregon is wood, obviously. Pre-computer, one of the key jobs in a saw mill is the sawyer who sat in the control booth and, as the logs came in, he mechanically shifted it around before the saw went through, so as to get the most wood out of it. It was a highly skilled, highly paid job. The operator is still in the control booth. Today it is a computer, and the computer scans the log and shifts it about. He is highly paid. He has to understand that computer.

But it is a different kind of education from the skill before. You really did not need even a high school education in the old days. If you had that skill in being able to look at that log and know how to tilt it to get the most wood out of it, you were valuable. But it was not a scientific skill, it was not an educated skill, it was a hands-on, learned skill.

Secretary REICH. Absolutely. One thing that we are going to be working with the 104th Congress on, hopefully, is consolidating all of these job training programs, making them streamlined, consumer-oriented, available to people wherever in their lifetimes they need additional job training and upgrading, and also encouraging employers to provide more training. Very, very important.

But this information issue is still a critical issue with regard to savings. People do not have the information, even if they can afford to save.

Senator BRADLEY. Mr. Secretary, thank you very much.

Secretary REICH. Thank you, Mr. Chairman.

Senator BRADLEY. Before you go, let me just say that a few weeks ago you made a comment about, if we are going to do welfare reform we need to also look and take on corporate welfare, and you referred to various sections of the Tax Code as possible places that we could look. And the then Secretary of the Treasury disagreed with you. My hope is the new Secretary of the Treasury will not disagree with you so much.

My suggestion to you is, you can get that corporate welfare and greater incentives for savings if you simply cut the rates and eliminate those corporate loopholes. So, maybe there is a little clue there for what we might do.

Thank you very much.

Secretary REICH. Thank you.

[The prepared statement of Secretary Reich appears in the appendix.]

Senator BRADLEY. Our next witnesses I would like to call as a panel and have each of them come to offer their testimony. And, as I call your name, I would like for you to please come to the table.

Ms. Mary Root, of Mountainside, New Jersey;. Mr. John R. Wantz, of Taneytown, Maryland; Mr. Richard J. Dunn, of the General Electric Corporation. I want to welcome all of you to the committee. I think each of you has a slightly different story to tell about your own interaction with the savings crisis, and I would like to, if you could, just go through all of your testimony and then we will get the questions.

So, why do we not begin with Mr. Dunn, and then Ms. Root, and then Mr. Wantz, if that is all right.

Mr. Dunn, the floor is yours.

STATEMENT OF RICHARD J. DUNN, GENERAL ELECTRIC CORPORATION

Mr. DUNN. Thank you, Senator for the invitation.

Like Secretary Reich, I am also an aging baby boomer. Since 1992, I have been the Plan Specialist for General Electric for its Qualified Benefits. These are defined benefit and savings plans which total almost $37 billion in assets.

I do not invest the money; my responsibility is the plan design and providing adequate retirement income for our employees. We have about 147,000 active employees, and we have almost a half a million participants when you include retirees and terminated vestees. It is a very large plan.

I was asked to speak a little bit today about the effect of early retirement on our people. There is a certain irony in that, because I just spent six weeks with our union compatriots in New York, debating the wisdom of things like, "30 and out," age 55 retirement, the "rule of 85," etc.

General Electric is generally against voluntary early retirement, for reasons I will clarify in a moment. But I think it is only fair to convey to you in the more colorful language that the union people tend to use, "thirty years is young for a tree," is what they tell me, "but it is a lifetime on the factory floor." I have not walked a mile in those shoes, so I take them at their word. But we think there are other societal factors that are making it more and more difficult to answer this challenge.

From our point of view, our plan already has an early retirement feature. An individual can retire in our plan at age 60 without any reduction. This is 5 years before the "normal" retirement age in the plan, and, very significantly, it is at least 2 years before the age 62 retirement that Social Security has as a guideline for reduced benefits.

We withstood a lot of pressure to adopt unrestricted voluntary early retirements and so called "window" programs, for three reasons that I would like to share with you.

The first one, which you are familiar with, and is in some ways the reason for this hearing, is American society is going the other way. People are living longer, Social Security begins later, and inflation—granted, it being at a 30-year low—it is a fact of life for potential retirees.

And, as the Secretary mentioned earlier, the defined benefit plans are not indexed. So, what is adequate when you are 60, 62, or 65, may not be when you are 85. In fact, it probably will not be. So, we have to look to other things, and certainly not encourage people to go out earlier.

Senator PACKWOOD. A question. Are there many private pension plans that are indexed?

Mr. DUNN. I could not give you the statistics. There are some, but they are not the majority, certainly.

Senator PACKWOOD. Relatively few?

Mr. DUNN. If I had to give a figure, maybe 25–30 percent.

Senator PACKWOOD. All right.

Mr. DUNN. And most of those, Senators, are negotiated through some kind of a union arrangement.

So, the societal pressures are the first factor. Secondly, we have no interest in subsidizing second careers. Now, what do I mean by that?

Well, one employee—and this is a real case—explained to me that he would love an early retirement program. He would then be able to go to work for another employer, which I believe was a competitor of ours. He would have our pension, and he would have a high salary. But the reason the other company could pay the high

salary was, they were not providing the medical and other benefits we provide for our retirees.

So, from our point of view, what we would be doing is subsidizing our competitors by having a generous and voluntary early retirement program. Again, in the spirit of fairness, the comment of the union people was that the second "careers" for many of their people were the kind of jobs that Secretary Reich talked about in fast food restaurants. Nonetheless, there is a group of people that can establish a second career. And we say, God bless, we just do not want to subsidize it.

But, finally—and this is something that I do not think you will read much about—early retirement is incredibly expensive to the plans and to the employers. Let me try to explain why.

If an individual retires at age 55, let us be realistic. They don't just get the pension. Almost all pensions, Senator are modeled on a three-legged stool concept, where Social Security is an important leg.

They are not going to get Social Security until age 62, so most employers, certainly General Electric, provide a Social Security supplement between retirement, which is usually age 60, and age 62.

When we extend the supplement down to age 55, it becomes a very big number. For the average employee at General Electric who leaves at 55 under our SERO program, that is about $8,000 a year.

Now, add to that the additional pension payments we required because we had expected retirement at 60, and our covering this retiree with medical expenses.

I spoke to Phil Ameen, who is the comptroller of General Electric, yesterday and our cost estimate, I think, is pretty accurate. If you ask me to estimate the additional expense of retiring someone at 55 rather than 60, it is probably $100,000 present value. That is a lot of money for an average employee.

The other side of it, Senator, is that despite the advantages and expenses I just went through, there is a GE program that we commend to your attention. We do not say it works for everybody, or it should be national policy. But it works for us and it works with dignity for the people involved. It is a program called Special Early Retirement Option, or SERO. Let me just explain it for a moment, if I may.

As I said before, the GE pension plan provides an unreduced retirement at age 60. One exception is someone who is disabled, because they cannot work till age 60, and we have a provision whereby they can get a pension earlier.

When you get to long service employees—and these are people, fortunately, who are not in the position of "Joe" that Secretary Reich was talking about, these are people who did work their whole career, they have been with us 25 years, and are age 55. We allow them an important option to take voluntary early retirement in the context of job loss events.

Now, to step back a moment. GE is extremely generous in providing early retirement to employees we impact. In other words, if you are a long service employee, as I just discussed, and we eliminate your job, you get an unreduced pension, you get the Social Security, you get the medical expenses.

We also have a program, which I believe, is unique in American industry. I have not seen it before, certainly. When it comes to hourly and nonexempt employees, we allow long service people to step into the place of someone else whose job who might be leaving.

Let me give you an example. Let us assume there is a unit of 20 people, and beginning next January we will only need 19 people. Now, generally speaking, of course, in the hourly, nonexempt jobs, it is seniority that governs who leaves. So, there might be a 23-year-old, for example, who would be out of work.

Under these circumstances, we will allow the 55-year-old, if he or she wishes—we do not encourage it, in fact, we largely prefer experienced people to be at these jobs—to step into the place of the younger worker. He gets this SERO benefit that I told you about before, with the $100,000 cost, and he leaves with a dignified, we think, and generally happy retirement, because he is out at a much earlier age than he thought. We have had tens of thousands of people take advantage of that program which has been in effect since 1988.

Our view is that this is not a choice between working and leisure—this is a choice between one person being unemployed and another person having a dignified retirement.

It is what our executive vice president, Frank Doyle, who has testified on labor issues numerous times, calls "situational" early retirement. In other words, we understand the societal factors and the expense, but there are some situations, such as this, where early retirement nonetheless makes sense. I would like you to keep in mind that it is a very, very expensive program, as I mentioned, probably $100,000 a person. But both our management and our employees—and that is a rare treat—appreciate the SERO program.

And, if I can make one final comment, I am glad to hear what was said early this morning by the Senators and by Secretary Reich regarding encouraging investment. ERISA just had its 20th birthday. When I was in law school, I remember I said, this will never work. But it has worked brilliantly.

Again, I refer you to the three-legged stool, which is the underlying concept of ERISA. You had the defined benefit plan the Secretary talked about, private savings, perhaps including the defined contribution plan, and Social Security. Well, Social Security and the defined benefit plan are pretty well there and understood, I think. If you work long enough, you get it.

But 401(k) plans have just become an extraordinary opportunity to add a fourth leg to that stool. And, whether it is education or whatever, people are not taking enough advantage of it. I have done focus groups on this issue, going out to some of our plants and talking to our people.

To me, it seems very easy. If you put in a dollar, we will give you 50 cents free of any vesting. You can take your dollar back out within a couple of months; and, still, 20 percent of our people do not participate.

So, I could not agree more about education, and I could not agree more with the idea that even when people do save, they have got to be educated how to invest their money. For example, I consider

myself a pension expert, but I missed about half of the bull market waiting for the crash to come, and I am still waiting.

In any case, we do not know if the SERO program should be national policy, we simply know that it works for us, and there may be situations where early retirement is appropriate.

Senator PACKWOOD. You are not alone, Mr. Dunn, in having missed the market. My hunch is, as best I recall, half of the best experts in New York on Wall Street missed that also.

Mr. DUNN. Yes.

[The prepared statement of Mr. Dunn appears in the appendix.]

Senator PACKWOOD. I cannot remember whether Senator Bradley said, Ms. Root, you were next, or Mr. Wantz.

Ms. ROOT. I believe I was.

Senator PACKWOOD. Go right ahead.

STATEMENT OF MARY ROOT, MOUNTAINSIDE, NJ

Ms. ROOT. I am Mary Lillian Root, who has been a resident of Mountainside, New Jersey for the past 38 years. If my voice happens to crack, this is a first-time experience for me, so please realize that I am somewhat nervous.

Senator PACKWOOD. We are just waiting to ask you very mean questions. [Laughter.]

Senator BRADLEY. You should just relax, Ms. Root.

Ms. ROOT. Thank you.

Senator BRADLEY. We are just very pleased to have you here, and really welcome your testimony.

Ms. ROOT. I am very pleased to have this opportunity to speak to you about the problems that women have had and still continue to have about pensions and saving for retirement.

As you know, that is a particularly important issue for women, since our life expectancy is longer than that of men. Often, women have found themselves not able to earn a pension due to the fact that they are caregivers for their children, their spouses, their parents, and perhaps spouse's parents or other members of their family.

I would like to, briefly, tell you about my own life, work history, retirement, and savings. I grew up in New York City at a time when there was a wonderful educational system of which I was most fortunate to be able to take advantage.

I attended Hunter College High School, went to Hunter College for 3 years as a free gift from the City of New York, which was wonderful, and then received my degree in Occupational Therapy at Columbia University.

I trained as both a teacher and occupational therapist, and, different from most women of my generation, I did work outside my home due to my particular circumstance. My husband of less than 7 years died of a coronary thrombosis and I was then in a position to use my education and support myself and my daughter, who was then 5 years of age.

Three years later I remarried a widower who had a son, so we had a daughter, son, and then shortly after that had another daughter, who is with me today, and with whom I was able to stay in Silver Spring so I could get here early this morning.

I opted to stay home for the next 8 years, which was something that most women of my generation did. Even though we had careers, we were, first of all, wife, mother, and homemaker.

After 8 years, I felt the need to reenter the field of occupational therapy and, therefore, I needed retraining, which I was able to receive at Children's Specialized Hospital, located in Mountainside, New Jersey. After that retraining, I have been in the work force ever since.

My second husband died after a very long illness, leaving me, unfortunately, without retirement benefits, for a period of 14 months. During that time, I had to tap my savings account to pay the monthly bills and my home equity loan. I needed also to borrow money from my daughters to pay the real estate taxes, which are ever rising.

This was a very stressful and difficult thing for me to do, because my only income at that time was a widow's pension, as well as the small income that I was earning as an occupational therapist employed on a part-time basis.

Luckily, I am a woman who pursues things, and I contacted the Older Women's League, the Pension Rights Center here in Washington, and I was told about a wonderful lawyer here in Washington who then helped me successfully resolve my problem.

Today I receive, as survivor benefits from my husband's pension, approximately $1,400 a month. That, with the widow's pension, gives me about $25,000 a year. I have also continued to work as an occupational therapist on a part-time basis within the Hillside School System in New Jersey.

It was not until very recently that I was able to access the pension fund. As the Labor Secretary mentioned, most part-time employees do not have this right. But the State of New Jersey has changed that for us, and I am very proud that they have been in the forefront in this area.

Now, I am able to contribute to this pension fund as well as an annuity fund. This is a forced savings plan for me, as monies are taken out of my salary on a bi-weekly basis. In this manner I have been able to accrue approximately $6,000. As part of my savings program, I have also contributed to IRAs. I feel I have been most fortunate in all those areas. At present, I continue to explore the options that are still open to me.

I hope that what I have been able to share with you has increased your awareness of the difficulties that women have faced, particularly in pensions for themselves and in saving for their own retirement. And, if there are any questions, I would be more than happy to try to answer them.

Senator BRADLEY. Thank you very much.

Mr. Wantz, you may begin. I have to leave for one minute. If you want to just hold until I come back, I would appreciate it. Thank you.

STATEMENT OF JOHN R. WANTZ. JR., TANEYTOWN, MD

Mr. WANTZ. Good morning, Senator Bradley, and members of the committee. I would like to thank you, Senator Bradley, for giving me a chance to tell my story.

Unfortunately, my health situation is serious and I am lucky to be here today. I recently had a heart operation and, at this time, I feel tired as well as disabled. At age 67, my wife and I are struggling to survive. I wish that I had known when I was younger what I am learning the hard way now, especially at a time when I most need help and most need the pension that I feel I deserve after 30 years of working as a plasterer.

I understand that you are interested in my financial situation, my savings, as well as my pension income. As of today, my Social Security benefit is $937 a month and my pension is $263 a month. My supplementary health insurance costs me $1,724 a year, or approximately $133 a month. I have a savings of about $20,000.

Since 1982, I have been trying to get someone to listen to my pension problem. I am not the only one with the problem. I know of other people in my situation who are having the same fight to get a pension. The part that upsets me the most is that we never really knew much about the pension and trusted those who were in charge. That is the way things were in those days.

We have been caught up in some kind of a technicality. What that means is that we do not get the pension that I worked 30 years for. The technicality is called "break in service." What that means is, when there is no work as a plasterer in one place, the union would send us to another place where there was work available. But the problem is, we were never told that being sent out meant you had a break in service and that you were not earning a pension.

At the time we asked questions, but we were told that there would be something worked out and we believed that it would be worked out. But we were never given the information that was needed in order to make the right decisions for our future.

People in charge of the pension tell us that it was written in small print. But, like most working people, we were too busy working and we never knew anything about how the pension worked or how the money was invested, or how much we would end up with when we came to retirement.

Senator BRADLEY. Mr. Wantz, thank you very much for your testimony.

Ms. Root, what I wondered, because your case is so illustrative, you said that you were a part-time worker and that not until recently had been able to make pension contributions. With your current contributions, do you believe that you are saving enough at this stage?

Ms. ROOT. At this moment, if I were to retire, I would only be able to add, out of my own pension fund, $67 to my monthly income, which certainly is not enough. So, maintaining health and continuing to work as a productive member of society is very important for me so that I can continue to add to the pension fund and my annuity fund, and thereby, when I do retire, have the options that will be available to me.

A woman in my situation looks at her home. Is it the proper time to sell this or should I stay and wait? At the moment I am doing that because it is close to work, and that is an important factor for me. I may eventually look into the possibility of a reverse mortgage. That is another option that may be open to me.

Senator BRADLEY. But you are basically saying that you have inadequate personal savings and that your only asset is your home, and, in order to live, you have to consider either reducing the equity of your home, or selling it?

Ms. ROOT. That is a real possibility.

Senator BRADLEY. And you think that in terms of your former husband's pension, it is not adequate?

Ms. ROOT. Not totally, no. But I am able to have health benefits through that. And, as many Americans are concerned about that, that certainly was a great concern of mine, so I am very happy that I have been able to receive this.

Senator BRADLEY. Do you have any suggestion for the committee as to what you think would be helpful to your circumstance?

Ms. ROOT. To my particular circumstance? Well, I think gathering as much information for women as to what is out there and available to them is most important.

Senator BRADLEY. And letting them know early what the circumstance is.

Ms. ROOT. Absolutely.

Senator BRADLEY. Mr. Wantz, given your health situation and your limited savings, how are you meeting your many health care costs?

Mr. WANTZ. Well, of course, I do have the supplementary Medicare.

Senator BRADLEY. So, basically, it is essentially Medicare?

Mr. WANTZ. Yes, sir.

Senator BRADLEY. Mr. Dunn, the SERO program, it sounds like an interesting program because it is kind of adapting to a changing workplace and work force, as Secretary Reich talked about. Is it used primarily by workers displaced by technological change?

Mr. DUNN. Yes. In fact, I am glad you asked that. I should have made that more clear before. That is right. Our productivity has gone up and the number of workers has gone down, or else the business would not be doing so well. But that is exactly where it is used, where someone has worked a long time for us in a successful industry where fewer people are needed, and that is who is taking advantage of it, to the tune of tens of thousands.

Senator BRADLEY. And how did it occur to you?

Mr. DUNN. Frankly, I cannot take credit for it, since I was a constituent of yours. At the time, I lived in New Jersey, Senator. In 1988, I would like to tell you that they studied it for hours and hours, but they worked it out one midnight in a hotel room to get the deals approved with the union, and it has worked brilliantly ever since.

As I say, in my experience, having seen any number of plans, this is unique, because what happens is just what you suggested, Senator. If the person is impacted, it is a very generous and dignified program.

And then the other thing is that we all hope the program will never be implemented because we always hope that everyone will have a job. But the reality is that everyone does not always have a job, and this is one way to ease that transition.

Senator BRADLEY. Yes. Well, I think that it is a very interesting idea. It certainly merits paying attention to and following.

I think each of you illustrate a different aspect of the savings crisis and I think that it is very important that we understand that these are not abstract numbers, but these are decisions that the society makes that will have a real impact on individual Americans. Certainly, Ms. Root, I think that you speak for a lot of women who find themselves in very difficult straits in their own later years.

And Mr. Wantz, I think you also speak for a large group of Americans who find the combination of health and the lack of savings coming together at a very critical time and hitting them on different levels.

I want to thank all three of you for sharing your views with the committee today. I know that all the committee members will find your testimony extremely helpful. I appreciate you making the effort to get here today. I think you have added a great deal to the hearing record. Thank you very much.

Our next panel consists of Theresa Ghilarducci, Ph.D., who is the Assistant Director of Employee Benefits of the AFL–CIO; Richard Thaler, Ph.D., professor of management, Johnson Graduate School of Management, Cornell University; Steven Venti, Ph.D., professor of economics, Dartmouth College. Let me thank all of you for coming today and for participating in these hearings. This is a very important issue. And, as you have heard from the first panel, it is one that has a very direct effect on individual Americans.

I would like to start with Mr. Venti, and then just go to Dr. Thaler, and then Dr. Ghilarducci.

Dr. Venti?

STATEMENT OF STEVE F. VENTI, PH.D., PROFESSOR OF ECONOMICS, DARTMOUTH COLLEGE

Dr. VENTI. Thank you, Mr. Chairman, for the opportunity to appear before this committee today. My name is Steven Venti, and I'm professor of economics at Dartmouth College, and a Research Associate of the National Bureau of Economics.

My recent research has focused on saving behavior in both the United States and Canada, with particular emphasis on what I call targeted retirement savings programs. These are the IRAs, 401(k)s and KEOGHs. Much of this research has been done with my colleagues, David Wise at Harvard University, and James Poterba, of MIT.

Previous hearings before this committee have documented the long-run decline in national and personal savings rates that jeopardizes both the long-term security of the Nation, and retirement security of future retirees. The part of the problem I will focus on today is policies to promote personal saving for retirement. Until recently, there has not been much of it. In 1982, for example, the typical American family on the eve of retirement only had about $7,000 worth of financial assets saved for retirement. Americans simply were not saving very much. And I believe that government policy can have, and has in the past had, a significant effect on saving for retirement.

In the short time I have here before the committee I would like to make three points. First, I will say something about the distributional issues surrounding these targeted retirement savings programs; second, I would like to say something about the saving ef-

fectiveness of these programs; and finally, I would like to offer some comments about why people save with these programs, and what lessons can we learn about designing programs to get people to save for retirement in the future?

The first issue is a distributional issue. Who uses these programs? Because these programs reduce taxes paid on capital, they are often criticized as benefitting primarily the wealthy. Yet most contributions to both IRA and 401(k) programs are made by middle-income families. There are many different ways we could look at the data, but let me cite just the results to summarize my argument. The first, is at the peak of the IRA program, about 1985, roughly 75 percent of all dollar contributions to IRA accounts came from families with incomes less than $50,000.

Now, we might get into a spirited debate over what is middle income, that elusive class we all claim to be a member of. Yet, I think $50,000 is well within reason here.

The second fact about IRA participation is that if you look at the 55–64 age bracket you will find that almost 50 percent of all families have an IRA in that age interval. That suggests that roughly 50 percent of all families at some time in their life will participate in an IRA program. So, their use is fairly widespread.

As for the question of who benefits from 401(k) programs, there are really two issues here. One, is eligibility. That is, does your employer offer the program? And the second, is do you participate given an offer of a 401(k) program by an employer.

As to the first, who is eligible, well, it turns out that higher paying firms are more likely to sponsor 401(k) plans, and large firms are more likely to sponsor 401(k) plans.

But, if a firm does sponsor a plan or offer a plan to its employees, participation rates are, in my view, quite high, on the order of 60–80 percent at all income intervals. Even at the lowest income levels, 60 percent of all persons offered a 401(k) by their employer participate. So, I regard this as a fairly high number.

It suggests that if we are concerned about the distributional effects of 401(k) plans, we probably should focus our attention on which employers offer these plans rather than who participates, given an offer.

The second issue is whether targeted retirement savings programs actually increase saving? This has been a controversial question, whether the money placed in these accounts is new savings, or perhaps 401(k)s and IRAs simply displaced saving that would otherwise have been done.

It is a controversial issue. We have spent a number of years looking at it. We have looked at a number of data sets. We have used many different statistical techniques and we have consistently come up with the result that these 401(k) contributions represent new saving.

Now, the prepared statement goes into a little bit more detail, and I refer you to some of our research papers. But let me just cite two facts about the IRA and 401(k) experience. If we go back to 1984, which is early in the IRA experience, we can ask the question, what is the median level of financial assets other than IRAs—stocks, bonds, savings accounts—that families participating in or contributing to an IRA held? The answer is about $8,500. So, your

typical IRA contributor had $8,500 of assets at this point in time, and then began contributing about $2,300 a year to an IRA. This suggests to me that the behavior of contributing $2,300 a year to an IRA was new behavior. These families had no prior history of contributing anything like $2,300 a year to retirement saving. The $8,500 number also suggests that these families did not have a great deal of assets they could simply shift into IRAs. They cannot sustain $2,300, $2,400, $2,500 a year contributions for very long with an initial stock of assets of only $8,500.

If we turn to 401(k) programs, a similar thing is true. We go back to 1984. This happens to be the year where data is available, that is, again early in the 401(k) experience. The median level of financial assets of families that participated in a 401(k) in 1984 was about $6,500. The typical contribution was about $2,000. So, again, families start contributing $2,000 a year to 401(k).

By the way, 401(k)s and IRAs are very persistent schemes; if you contribute 1 year, you are more than 80 percent likely to contribute in the subsequent year. It is pretty clear that the families that began participating in 401(k)s when they were offered had no prior history of saving anything like $2,000 a year. So, that sort of evidence, as well as much more formal models, suggests to us that much of the saving in 401(k)s and IRAs is, indeed, new saving.

So, what did we learn from the experience that can help direct future efforts to devise policies to increase saving? Well, after spending nearly a decade looking at these programs, one of the things most evident to me is that any analysis or evaluation of these savings programs must recognize that they are more than simple financial incentives. It may be heresy among public finance economists, but the IRA and 401(k) programs are more than just simply tax breaks. There is a lot more going on. In particular, I want to emphasize the many psychological factors that are involved in the savings decision.

There are several examples in my written testimony that I will not refer to here about where psychological factors come into play, but let me just ask the question; why don't families save more for retirement, and what can we do to get them to save more? I want to emphasize three factors not usually incorporated in our narrow financial or economic models.

The first, is that saving requires willpower, self— control, discipline. You have to give up something now for the future. IRAs and 401(k)s address this shortcoming by providing families with a mechanism, both by a penalty for early withdrawal—it has to be for retirement—as well as their promotion as narrowly targeted for retirement. This gives people a mechanism to commit themselves to a long-term savings strategy.

The automatic payroll deduction of 401(k) programs probably serves the same purpose. It gets you to commit to a saving strategy. Saving no longer has to be a conscious, day to day decision. You do not have to decide, how much of this week's paycheck should I save? You make that commitment once in the beginning of the year and you follow it. So, IRAs and 401(k)s help us commit to saving.

The second point, and this is something that Secretary Reich emphasized and I completely agree with what he said, retirement is

far off in the future and your standard of living during retirement, how much money you will actually have, is very uncertain.

It is a very difficult thing for most people to forecast what their retirement income is going to be. As a consequence, it is very difficult for people to decide how much money they actually have to save for retirement.

Well, what can they do? How can people form some sort of forecast of how much money they will need in retirement? One thing they can do is they can look around and say, how much is everybody else saving? If they do that, this suggests that any sort of campaign or promotional effort may bring results. I was happy to hear the Secretary say the Department of Labor is going to institute the National Pension Information program to do just this. This information dissemination, I believe, is important. In fact, it may underlie the high participation rates of 401(k) programs where, if your peer group of employees are doing it, why don't you do it?

The third, and final point, I think, that can be learned from our IRA and 401(k) experience is that the surest way to get people to save is to give them an immediate reward for saving. The up front deduction in the IRA program is a powerful incentive to get people to overcome a general reluctance to save for their own retirement.

We saw this after the Tax Reform Act of 1986 eliminated deductibility for a large segment of the population for IRAs. These families who lost their full deductibility were still eligible for nondeductible IRAs. Now, a non— deductible IRA gives you a higher rate of return than conventional savings vehicles, yet nondeductible IRAs have not generated much interest, despite the fact that there is a financial incentive to invest in them. The thing that is missing here is the up front deduction. I think it is very important. And it also suggests, perhaps, that back-loaded schemes, which are, of course, financially equivalent to the original IRA, may not be successful because they do not give an immediate reward.

Senator BRADLEY. Thank you very much, Dr. Venti.

[The prepared statement of Dr. Venti appears in the appendix.]

Senator BRADLEY. Dr. Thaler?

STATEMENT OF RICHARD H. THALER, PH.D., PROFESSOR OF MANAGEMENT, JOHNSON GRADUATE SCHOOL OF MANAGEMENT, CORNELL UNIVERSITY

Dr. THALER. Thank you, Senator Bradley, for this opportunity to talk about saving.

Much of what I am going to say will reinforce what Professor Venti has just said. Let me say something, first, about my background. I, like Steve, am an economist, but I am something of an unusual economist. I am as interested in psychology as economics. I teach at the Cornell Business School, and this year I am spending at MIT at the Stone School of Management. What I do is sometimes called behavioral economics. Today I would like to offer you a behavioral economics perspective on saving.

This perspective stresses two factors normally ignored in economic discussions of savings: self-control, that Steve mentioned, and what I called mental accounts. I will try to explain how these factors are important to the formulation of a national savings policy.

Problems of self-control are all too familiar to most of us, as they have been since the time of Adam and Eve. That self-control is important to saving is obvious to any parent. Piggy-banks are an example of a self-control device invented to facilitate savings in young children. I am referring to those piggy-banks, of course, where it is easier to put money in than to take it out. However, it is not just children who face self-control problems in dealing with savings.

For anyone who must restrict consumption because of a limited supply of money—that is, all of us except the very rich—saving depends on the ability to delay gratification. I can only put money away now for later if I refrain from spending it now.

In stressing the role of self-control in understanding saving, I might be accused of belaboring the obvious. However, though it may be obvious, self-control is never mentioned in traditional economic analyses of saving. The standard theoretical model assumes that people simply calculate how much they should save for retirement and then act accordingly.

The fact that few people are capable of making the necessary calculations, and even those who can make the calculation may lack the personal resolve to stick to the rational plan, is never mentioned. A simple look at the data reveals how important self-control is to personal savings.

As Steve mentioned, most people, when they reach retirement, have very little in liquid assets. The only important forms of saving in this country are Social Security wealth, pension wealth, paying off your home. These are what most people refer to as "forced saving," something that does not require willpower.

Like Odysseus tied to the mast, these forced saving mechanisms eliminate the need for self-control. It is a good thing that these forms of savings exist because other forms of saving, so called "discretionary saving" do not amount to very much.

The second factor I would like you to consider is the role of what I call mental accounts. An example would illustrate what I mean by a mental account. Some casino gamblers adopt the habit that when they win some money, they put their own money in one pocket and their winnings, which they call the casino money, in another pocket. These two pockets can be thought of as two mental accounts.

To understand how these matter to the study of savings, it is important to realize that the theoretical agent in the standard economics model treats all assets as fungible, that is, nearly perfect substitutes for one another.

This idealized economic agent responds to a $10,000 lottery windfall in exactly the same way as a $10,000 increase in home equity or in pension wealth.

In contrast to these theoretical actors, most real people do not treat all forms of wealth as equivalent. Instead, households allocate funds, implicitly or explicitly, into categories or mental accounts. Some funds, for example, those in checking accounts or in cash, are designated for current consumption. Others, for example, those in the savings accounts, are for rainy days or special occasions. There might be subcategories here: one fund for the children's education account, one for a vacation, and so forth.

Self-control and mental accounts come together because mental accounts vary in how tempting they are to invade. Money in your wallet is more tempting to spend than money in your checking account which, in turn, is more tempting than the money in the savings account. Even less tempting are funds explicitly set aside for retirement, such as money in an IRA or 401(k).

Understanding the role of self-control and mental accounts is essential for formulating good policy about tax incentives for saving. A good program must help overcome self-control problems in two ways.

First, it must offer an immediate inducement to save, a sugar-coated pill, if you will, to overcome the natural temptation to spend on immediate pleasures.

Second, it must facilitate the preservation of savings once money has been put away. A piggy-bank does little good if the coins can easily be shaken out.

To see how we can use these concepts to help evaluate policies to increase saving, let us consider 401(k) plans. From a behavioral perspective, 401(k) plans have five attractive features: (1) the up front tax break gives savers an immediate reward for saving; (2) when firms offer to match some or all of the employee's contribution, this immediate reward is enhanced; (3) payroll deductions are the easiest way to save; what you do not see, you cannot spend. (4) Once the payroll deductions are started, no additional action is required to keep putting new funds into the account. Inertia, often a problem in and of itself in saving, thus helps the flow of 401(k) saving. (5) The penalty for withdrawing funds helps reinforce the mental accounting designation of these funds as off limits.

Notice these arguments I have offered in support of 401(k) plans have been made on purely theoretical grounds, without use of any supporting data. On the basis of behavioral economic theory, 401(k) plans look good. Of course, on the basis of standard economic theory, many economists have decided—not my friend on my right—that 401(k) plans look bad. Who is right?

We can choose between these competing theories in two ways. One, is to do careful, empirical studies to measure the impact of the program. I will share my reading of those with you in a minute.

Before doing that, however, I invite you to ponder the competing theoretical arguments on their own merits. Which theory do you find more plausible? If you believe that most households have no self-control problems and treat all assets as fungible, then you should be skeptical about 401(k)s, IRAs, and so forth, as many economists are.

On the other hand, if you think most households do find saving difficult, are more likely to splurge from their savings account than from their retirement account, then you have every reason to believe that these plans may be highly effective.

What about the data? My own reading of the empirical studies leads me to conclude that these programs have been very successful at increasing saving, just as the behavioral analysis would predict. I am going to skip that because Steve has covered it quite well in his.

Senator BRADLEY. Dr. Thaler, if you could finish up in a couple of minutes.

Dr. THALER. Sure.

So, let me just make one point about these empirical studies which is rarely discussed. Most of the analysis has been as to whether the money comes from a savings account or whether it is shifted. I think this is looking at the wrong issue. Instead, what we should be looking at is where the money stays. IRAs and 401(k)s work because they take money, even from a savings account, and put it into a place where it is less likely to be spent.

The last topic I would like to talk to you about is the design of new savings vehicles. There is interest now in bringing back some kind of IRA, making it more popular and available to more people. Many of the new programs are back-loaded. Under this plan, the tax break comes when the money is withdrawn rather than when the money is contributed.

Now—although these plans are supposed to be equally attractive—I think nobody believes that real people view an inducement 20 years from now as attractive as one right now. So, if they would not work, why are they so popular? I think the reason has to do with another self-control problem, this one within the U.S. Congress.

By back-loading the tax break, today's Congress can shift the cost of the program outside the five-year budget planning window and onto another generation of Senators and Representatives This is seen as a way to buy increased saving today and not have to pay for it for many years.

It is exactly this kind of thinking that prevents many Americans from saving, and Congress will not be setting a very good example if it falls into the same trap. While myopic accounting rules make back-loaded IRAs look deceptively good, the same rules make front-loaded IRAs look deceptively bad. When people take money out of IRAs they have to pay taxes on those withdrawals, and there is an identity here which is, if the programs are equally attractive to savers, they cost the same to the government. It is only if we only weigh the up front cost.

Very quickly, let me make one other very simple, costless proposal. Under existing law, to claim a tax deduction for an IRA, a family has to have made the contribution before the tax return is filed. Why not let taxpayers designate their income tax refund to go to an IRA? We know that most taxpayers do receive refunds and that many taxpayers intentionally overwithhold to assure this outcome, knowing that they find it hard to save in other ways. Under my proposal, a taxpayer with a $1,000 refund could instruct the IRS to send the refund check directly to the financial institution where is IRA account was held.

If this option were elected, the check would be increased by the taxpayer's marginal tax rate. So, if the taxpayer were in the 28 percent tax bracket, he could choose between a $1,000 cash refund or a $1,280 contribution to an IRA. For middle class taxpayers, I think this will be a popular option and one that is virtually costless to the government.

Senator BRADLEY. Thank you very much, Dr. Thaler.

[The prepared statement of Dr. Thaler appears in the appendix.]

Senator BRADLEY. Dr. Ghilarducci?

STATEMENT OF TERESA GHILARDUCCI, PH.D., ASSISTANT DIRECTOR OF EMPLOYEE BENEFITS, AFL–CIO

Dr. GHILARDUCCI. I, too, am a card-carrying economist. I am recently with the AFL–CIO as Assistant Director of Employee Benefits, but for the last 11 years taught labor economics at the University of Notre Dame and spent my career looking at the labor market, especially the retirement income security programs that come out of it.

But, unlike my colleagues, I am not charmed by 401(k) plans. And when I look into the abyss of retirement income security, I find them to be very feeble efforts by the government to try to stem the crisis.

So, I will focus not only on the behavioral aspects, even though I did in my written testimony, nor on the evidence about what 401(k) plans have done, but really try to answer your call for the panel, which is to talk about institutions that really do promote savings norms.

I am going to echo something that Secretary Reich said today, and it cannot be overstated, that the real wage decline has caused much of the decline in savings. It has not been a materialistic culture, or something special about the baby boomers that make us unable to delay gratification, it is just that, since 1973, real wages have not increased. So, many economists have identified that people have borrowed, not to increase their standard of living, but to maintain their social position. So, we find this borrowing to be something very different than, as popularly conceived of, it is necessity or necessitous borrowing.

So, given that view of what households are doing and why we have created this culture of debt, we have to look at institutions to turn this around. And part of those institutions will be raising real wages, but I will talk about institutions that can do that without doing that.

Employer pensions, these traditional, defined benefit plans that Secretary Reich referred to, are institutions that help people save, in contrast to these individualistic solutions. So, I am going to tell you of kind of a black and white world.

In the black world of individualized savings—and I really do not care if they are IRAs or 401(k) plans—they are individually motivated, and this other world of institutionalized collective ongoing kinds of savings.

Now, we all know that these pension savings, these institutionalized savings, was the key source of personal savings in the 1980's. John Shoven has done quite a lot of work on this. Corporate plans, however, increase their pension savings because of financial markets. Corporations, individual investors, even chimpanzees, if they invested, earned a lot in the 1980's on speculative financial markets. But they cut their pension contributions because corporations, institutionally, have a conflict of interest as pension savers. When the going gets rough, or for whatever reasons, they withdrew savings and their target contributions to employer pensions.

On the other hand, union pension plans, which cover workers that we like to talk about who are most at risk of poverty in retirement and who are the new work force, these contingent workers who have skills, but they go from job to job, sometimes with a

break in service. These are garment workers, construction workers, mine workers, longshoremen workers.

Even though they have crummy jobs, by all rules of textbooks, they have really good pensions. That is because of an overarching institution, unions, have organized these plans and they have been doing it for decades. They are really actually quite exciting models.

In those plans, they increase pension savings because employers and unions, because of good laws, could not withdraw them. So, that is a world I really want to talk about at some point.

Now, I want to talk about how collective institutions do promote savings. Let me refer to unions again, because I want to turn around some commonplace notions. Unions are often looked at as a way that workers secure more consumptions, but they really are institutions, and whether they be unions in the AFL–CIO or professional associations really does not matter here. But those kinds of collective institutions can nurture savings.

For instance, pensions, people might not know, were the leading causes of strikes in the 1950's. They remain one of the top bargaining demands of workers when they have a say. They want pensions, other kinds of security, and then wages. Sometimes wages are fourth, when they are asked.

Workers together, in collective institutions, will go on strike, give up weekly wages, in order to save for the long term. Now, we need probably public policy that can support those kinds of collective institutions. Professor Venti has done fascinating work on behavioral aspects of individuals. I want to refer to a consumer culture that is just too difficult for workers or people to reduce consumption now for an uncertain period later.

Economist Veblin, in the 1930's, coined the very interest term "conspicuous consumption." He just pointed out, as Professor Dusenberry and other really good economists later have shown, that people consume to maintain a social position.

So, if they have to individually, rationally choose to save, the rational thing is to not save. It is to do other things with the small savings they have, but not to save for retirement. The only way you can get people to change their consumption is that everybody in the same social position saves at the same rate.

Let me give you two examples. One, is the Central Pension Fund of the operating engineers. Again, these are workers on cranes, digging with bulldozers. They only work about 9 months out of the year.

This pension fund gives the middle class incomes into retirement because every time they go from a job to a job, the employer, through the union plan, puts some money in the plan. These are wonderful hybrids between defined contribution, these 401(k)–IRA types, and these defined benefit plans that are probably waning in popularity.

The other example, is my pension plan, TIAA–CREF. You will hear of it from representatives this afternoon. It is the largest pension plan in the world. It is only good for me, not because I am a great economist and defer consumption, but because it forces me to save, another example, and I cannot withdraw, unlike 401(k)s and IRAs.

I just want to conclude by saying that the direction that we are going in, with Secretary Reich and the kinds of remarks made at these hearings is very unique in the world. We are the only country heading toward a retirement system.

And I guess in the back of my mind is the work of your colleagues, Senator Kerrey and Senator Danforth, in the Entitlement Commission, that are looking forward to individuals to decide their own retirement security. Other nations do not depend upon individual decisions. Like you said yesterday, thousands and thousands of decisions cannot make one collective decision for good retirement.

So, I want to say that there is really a continuum of policies that you can entertain here. On one extreme are these individualized savings plans that we could spend more and more energy on, more and more education on, try to bully from the pulpit the importance of acting like a professional financial manager. I am afraid that instead of training people for the skills they need for their jobs or basic math skills, the Department of Labor may be spending too much time on this and actually may take away from productive capacity of the economy and reduce wages further, feeding back on savings. It may not be a good use of time and energy for education.

In the middle of the continuum are collective institutions. Collective institutions, like TIAA–CREF, union plans, maybe all the other things we could think of if we did not spend all of our time on 401(k) plans. And, on the other end of the continuum, folks have talked about our mandatory savings plans that would add on a second tier for Social Security. I like the middle road. That is why I put it in the middle. But that is really what is part of our country's heritage, and really what has grown out of this different interest and I look forward to talking to you and my colleagues about it.

Senator BRADLEY. Thank you very much, Dr. Ghilarducci.

[The prepared statement of Dr. Ghilarducci appears in the appendix.]

Senator BRADLEY. Let me ask Dr. Thaler, basically, your argument is that an IRA is better than an ordinary savings account because it is harder to get to and, therefore, less likely that it will be removed, therefore, savings will increase. Is that basically as I read your testimony?

Dr. THALER. Right. Right. That is exactly right.

Senator BRADLEY. Have you considered the loss of public savings that are associated with the tax incentive and with the impact on long-term economic growth and productivity of the increased deficit?

Dr. THALER. Well, I am not sure that I have anything very useful to add on that question. Obviously, if we want to give people an incentive to save and we are going to have to fund it now, it is not good if we do it with deficits. But I do not think that it is any better to fund it with deficits 10 years from now, which is what the back— loaded plans do. There is no way around the fact that if we shelter some saving from tax, that we postpone some tax revenues.

Everybody is going to have to exert some self-control if we are going to increase national savings. And if we want people to do it, we have to give them an inducement to do it now. If the government wants to play a part in it, it is going to have to figure out some way of paying for it.

Senator BRADLEY. Well, I guess one of the questions, and I can move to Dr. Ghilarducci here, relates to the recent OECD study that tried to make the point that the increased personal savings that come from certain tax— favored savings vehicles are really not as important as the education efforts that surround the tax preference itself. Based on your experience, what do you feel accounts for increases in private savings? The Dr. Venti reports are associated with such things as the tax-preferred savings in the Canadian system.

Dr. GHILARDUCCI. If I can take an historical perspective, workers started saving for retirement around 1935 in the midst of the Depression. The passage of the Social Security Act was a great surprise to the insurance executives who opposed it, but they were pleasantly surprised that the act actually increased demand for their annuity products. After the depression and after the war when workers could start assessing what they wanted out of this great golden age of American economy, they decided they wanted to increase their pension plans. So, it is not only education, it is also the vehicle. We could give them brochures from the Department of Labor, or pamphlets from Fidelity, but the Social Security system cannot be ignored as an important source of an impetus to save.

Daniel Yankelovich, in a Competitiveness Council meeting earlier this fall, talked about how, in his focus groups, folks, when they find out how much they have to save for retirement—at 37 I should be saving 30 percent of my income. TIAA–CREF makes me, but most of my 35-year-old friends do not—feel just hopeless and just stop. What knowing about Social Security does, is eliminate that feeling of hopelessness and say, hey, I have a base, let me build on it. I think that is a very important psychological moment, much more important than this education effort.

Senator BRADLEY. So the combination, you view, is Social Security and the education effort.

Dr. GHILARDUCCI. Yes.

Senator BRADLEY. Yes.

Dr. GHILARDUCCI. And collective bargaining, actually, becomes a very important educational moment. And when do workers get to come together and talk about what they want out of life?

Senator BRADLEY. Dr. Thaler, what do you think of that?

Dr. THALER. Well, I mean, let me just reinforce that I like 401(k)s and IRAs. I think they are good programs. But private pensions of all sorts, there is really no substitute for that. And the one thing I think that I would urge you to do is fend off attacks on private pensions.

The firms are doing us a lot of good by getting people to put money into their private pension. I have a 25-year— old daughter who has a great deal of difficulty saving, and she has just recently taken a job at a firm with a defined contribution pension plan where, if she puts in four percent, they put in 9 percent, and she is actively saving. I think she is actively saving for the first time in her life.

We need to do what we can to get firms to have every incentive to do that. Some of these little wrinkles, like these rules about how everybody in the firm has to contribute to maintain the tax rules,

I think, do a lot of good because the firms encourage people to participate.

Senator BRADLEY. Dr. Venti, in your testimony you came out with one view of the 401(k). I think in the academic community there is a kind of disagreement as to whether it increases national savings.

There is a question that it increases individual savings, but there is an offsetting loss of public resources that increase dissavings at the governmental level. So, there is a dispute about that, but I do not think there is any dispute about who benefits from the 401(k)s. They are obviously the people who have the resources that allow them to save.

My question is related to something called the "Hurdle Savings Plan," where you have to save a percent of your income before you get the tax benefit. Does that make any sense to you?

Dr. VENTI. Well, it is certainly an interesting proposal and I think, in principal, it has merit. I guess my one fear is that it is not simple enough to sell. It is a somewhat complicated plan and it is going to be somewhat complicated to put into effect. People's marginal propensities to save rise with income, so it is going to be very difficult to set the hurdles. I also foresee problems of people bunching income, constructive realization, saving in alternate years to get the saving incentive, and those sorts of gimmicks.

On top of that, there is also going to be some problems when you take the money out: what is the tax treatment on it? So, if I could also address the previous question you asked Professor Thaler earlier——

Senator BRADLEY. Sure.

Dr. VENTI [continuing]. And something you just brought up a moment ago, about the national saving effect of these programs. I am not in favor of deficit financing IRAs or 401(k)s. But, if you take a dollar, given our best estimates, and you put it into an IRA, roughly 20 cents of that dollar came out of money you would otherwise have saved, 30 cents comes out of decreased tax revenues. That is a negative national saving. The remaining 50 cents is an increase in personal savings.

So, even though it increases the deficit, as long as the amount of personal saving exceeds the loss in government saving, there may be an increase in national saving, despite the deficit financing.

Senator BRADLEY. Do you have any specific ideas for increasing private savings without increasing the Federal deficit?

Dr. VENTI. Well, I think a number of those have been alluded to earlier. I think the system that Secretary Reich talked about informing people, the promotional campaign, may do a lot of good. We certainly had a system during World War II with war bonds where we had 80 percent of the adult public contributing to what was not a very financially attractive vehicle. Certainly promotion had a lot to do with that. I am a strong believer that promotion and marketing of these kinds of programs has a lot to do with it.

Senator BRADLEY. Yes.

Dr. VENTI. You may be able to scale back a little of the tax break and still sell these things. For instance, it may be possible—I have not thought it through very well—to take 401(k) plans where, right now, people that contribute to a 401(k) plan have two immediate

benefits. One, is that there is matching. That gets them to contribute. The other is, it is tax deductible. That gets them to contribute.

Perhaps you could scale back one of the two. For instance, make the employee contribution in after tax dollars yet have the employer contribution tax deductible, and still have employer matching. If you market that, it may possibly work.

Senator BRADLEY. Dr. Thaler, do you have any thoughts about what Secretary Reich said and what the figures bear out, that only 19 percent of those people who work for firms of under 25 are covered by a pension?

Dr. THALER. Well, the only thing I would say is——

Senator BRADLEY. Well, how would you encourage this small firm to cover workers?

Dr. THALER. Two things. One, is streamline the regulations. I mean, one reason why we have seen all these defined contribution pension plans is they are a lot easier to administer. I think if we can give these small firms an incentive to adopt those sorts of plans and try our best to keep the paper work overhead as little as possible, workers like them. I do not think we have to work too hard at getting the firms to do it if we do not make it too onerous.

Senator BRADLEY. Dr. Ghilarducci?

Dr. GHILARDUCCI. I just want to remind you, I am really not speaking as a labor union dinosaur, I really am looking forward to the future. But, looking back, I see these union plans, these collective multiemployer plans, there must be some other way we can encourage it without me saying, you know, labor law reform. But I really want to stress, these are plans with tiny, little employers, little contractors, coal miners.

They are there because workers needed pension plans from small employers. So, I think we really should not focus on the individual worker's behavior, but institutions that can foster, sort of, collective action.

Senator BRADLEY. Or some combination of the two.

Dr. GHILARDUCCI. It will take both.

Senator BRADLEY. What percent of unionized workers have a pension?

Dr. GHILARDUCCI. It is amazing. It is 90 percent.

Senator BRADLEY. 90 percent.

Dr. GHILARDUCCI. Yes.

Senator BRADLEY. And what percent of the nonunionized work force?

Dr. GHILARDUCCI. It is about half that. Actually, a little bit less than half of that.

Senator BRADLEY. Yes.

Dr. GHILARDUCCI. And that is my best evidence for the promise of collective action.

Senator BRADLEY. Dr. Venti, in your view we have all of these different vehicles, IRAs, 401(k)s, 403(b)s, SEPs, which are the new approach. How might simplifying the regulations associated with these plans boost private savings?

Dr. VENTI. Well, I think one of the problems with traditional employer-provided pensions, the DB plans and the DC plans, has been that the law has changed so many times over the past 15 or so years that the administrative cost of just complying with the law

is enormous and it discourages firms from offering these kinds of plans, particularly small firms. I think if there is progress to be made somewhere, it is lowering the cost, particularly to the small firms, of adopting these kinds of plans.

Senator BRADLEY. Dr. Ghilarducci?

Dr. GHILARDUCCI. I just want to say that the folks I am talking about who have been in small employer plants with pension plans never said, in interviews that I have had with hundreds with them, or in their documents, that the tax break ever mattered.

If you got rid of the tax break for pension plans there would be a hue and cry, but I do not think it would really lower whatever lower income individuals save now through collective or individual savings. I mean, that is actually quite amazing. The tax break is not that important for lower income folks as it is for higher income folks.

Senator BRADLEY. Dr. Thaler, do you have anything to add on that point? I mean, you say we need self-control and responsibility. We have heard a lot of arguments today about individuals who spend to maintain their social position, essentially their standard of living has eroded. And, based on your research, do you believe that once people have the information that they are going to develop the self-control?

Dr. THALER. No. I do not think that information is sufficient. I think that it helps, and scaring people helps, but peer pressure helps as well. It is funny, when you are in a business school or an economics department at this time of year, your colleagues are talking about KEOGHs and 403(b)s and so forth. And if more people were confronted with that kind of talk at year end or in April, those kinds of things would help as well.

I mean, I agree with Steve. We do not know what is the crucial part of these packages, what makes it work, whether it is the tax break or whether it is the up-front something. What we do know is, once the money gets in there it tends to stick. Somehow we need ways of getting people to take money out of their pocket and put it somewhere where it will stay.

Senator BRADLEY. Well, are you in favor of mandatory savings?

Dr. THALER. Well, I mean, I would be in favor of a radical plan where we funded Social Security, just told people they had to save. I mean, I think that would be——

Senator BRADLEY. That is right. So, you are in favor of mandatory savings over and above Social Security?

Dr. THALER. Well, I do not have a specific proposal, but I think that something like a required saving rate, especially for self-employed, would make a lot of sense and take a lot of pressure off the Social Security system when people our age are going to retire and our kids are going to have to pay for it.

Senator BRADLEY. What do you think of that, Dr.

Ghilarducci?

Dr. GHILARDUCCI. Well, I like it, personally. It is not a position of the AFL–CIO at this moment. But, remember, the flip side of saving is investing. If you have people mandatorily putting away money, it probably will not cost the Treasury that much because lower income people will contribute quite a bit and that tax loss is

not that great. They are going to want to have a say where those investments go.

So, part of the education about savings is the education about, be a responsible investor. So, at the same time workers are savers, they also will become or want to become empowered shareholders and want some say in corporate governance. So, it is a very interesting and quite a radical proposal.

Senator BRADLEY. Given what you have done on mental accounts, Dr. Thaler, what do you think the impact of the phenomenon of people borrowing against their retirement fund is going to be on retirement security?

Dr. THALER. Well, I do not much like it. I worry——

Senator BRADLEY. Should we make it more difficult to borrow against this fund?

Dr. THALER. I would. I do not like some of the new plans where you can withdraw the money for lots of different reasons. I think that that is a bad move. I do not think that this is a big problem. For example, even the home equity loans, my reading of the evidence is, it has not added up to as much as we might have worried. Most people who borrow pay it back. But I think it is something to keep our eye on, and we do not want to make it too easy.

Senator BRADLEY. All right. Let me thank all three of you for your testimony. I appreciate you sharing your time with the subcommittee.

Our next panel consists of Dan Halperin, professor of law, Georgetown University; John McCormack, executive vice president of TIAA–CREF; Sylvester Schieber, vice president, The Wyatt Company; and Sarah Teslik, executive director, Council of Institutional Investors.

Let me welcome all of you to the subcommittee. We welcome your testimony. If you are ready, why don't we begin with Mr. Halperin, and then go right down the line,

Mr. McCormack, Dr. Schieber.

Mr. Halperin?

STATEMENT OF DANIEL I. HALPERIN, J.D., PROFESSOR OF LAW, GEORGETOWN UNIVERSITY LAW CENTER

Mr. HALPERIN. Thank you, Senator. I wanted to discuss the possibility of enhancing retirement security through employer-based plans.

First, let me say that if the goal is universal coverage, so that we could expect all employees to have retirement benefits in addition to Social Security, which will enable them to continue their pre-retirement standard of living, I think we have to recognize that voluntary employer plans or individual savings will always fall short. Even many years into the future, we can expect that at least one third of employees will not have private pensions and many that will have pensions will have insubstantial amounts.

So, the only way we can ensure an adequate rate of retirement savings—if you view that as an important goal, as you have just discussed—is through mandated coverage, either through Social Security or through employer plans. I recognize that there are objections to either of those approaches which would seem to make action unlikely, at least at the moment.

What we have to face up to is whether those objections are stronger than the case for universal coverage. I do not think we should fool ourselves into believing that universal coverage is otherwise obtainable. With that said, I believe marginal improvements can be made in the coverage of employer-sponsored plans.

I think, most important, and something that probably can be done, is to reduce the use of retirement savings for pre-retirement consumption. Much in the way of private savings is now consumed prior to retirement. People do get lump sum distributions, increasingly, when they terminate service. Studies show that a substantial portion of these lump sums are consumed and not saved for retirement. There are various ways that one can try to reduce that.

I think probably the least radical might be to require that employers have to put the money directly into Individual Retirement Accounts, or IRAs, or into a subsequent employer plan, then to try to rely on the rules of inertia, that if an employee has to go get it, he or she is less likely to do it. So, that might preserve savings for those who have it to begin with.

What about people who are never covered by employer plans at all, or are covered for relatively small portions of their working life? I think there are two problems here. First, employers with plans do not cover everyone in their work force, and, more important, many employers, particularly small business, do not have plans to begin with. We have to recognize that there is a dilemma here. We give you a tax incentive only if you have more widespread coverage than the employer and probably the employee desires.

We are trying to get people to do what they do not want to do by offering them tax breaks if they do it. We have to recognize that if we push that too hard, people say, no thank you. So, we have to really walk a tight line into trying to figure out what is the best level of regulation.

In trying to get employers to cover everyone that is working for them, I would require qualified plans to cover all employees, or at least all employees in the line of business, once they have met minimum age and service requirements.

I think a classification allowing people to differentiate between different categories of employees is not only extremely complicated, but it tends to reduce some coverage. But we cannot be sure about that because, as I said, if you do make the rules tougher we might have some employers say, I would rather not have plans.

So, that leads to the question of how we can make plans more desirable for those that do not have one, or for those who might think about terminating as the rules become more stringent.

As you discussed a few minutes ago, one of the problems that certainly small employers raise is the administrative cost. So, the question is, is there anything we can do to minimize the cost for employers desiring to make retirement contributions?

One thing I think that has been thought about is some sort of a central fund, perhaps under the control of Social Security, to which employers, who do not want to establish their own plan, could contribute, or perhaps we can have private organizations market along those lines.

I think beyond that the only way to increase interest in retirement plans may be to increase the tax incentives. I certainly hesi-

tate to think along those lines because it seems to me that dispersion of the tax expenditures, to begin with, can already be said to be unfair, but certainly it is worth at least exploring.

A possible approach along those lines is to say to employers, if you cover everybody and you make a significant contribution for everybody, then we can let you, with additional contributions, somehow scaled to the amount of the contributions that you have already made for the lower paid, be free from the nondiscrimination test, or at least on parts of the nondiscrimination test with respect to the additional contributions.

That is important, because I think the main barriers to additional plans occur in those situations where employers have a large number of lower paid individuals who are not that interested in retirement savings compared to the number of higher paid.

In one-person companies—I get some consulting income on my own. I do not have any problem setting up a KEOGH plan. I do not have to cover anybody, and discrimination rules are not a problem.

But, if I had 20 employees and had to make contributions on their behalf, then it becomes much less valuable to make them for myself if I cannot cut their pay. So, the question is whether we can target and perhaps increase the tax benefits in that situation. I think it is at least worth looking at. Beyond that, I do not have any ideas at the moment.

The proposals that I have suggested would reduce flexibility, but they are definitely simplifying and I think it will test the idea that we often hear, that complexity is what stands in the way of increased coverage.

I think we will find that most of the complexity comes about because employers want to be able to demonstrate that they do not discriminate in as many different ways as they can think of. That is what causes the complexity. One would hope a simplifying rule would lead to increased coverage, and I think it is worth trying.

Senator BRADLEY. Thank you very much, Mr. Halperin.

[The prepared statement of Mr. Halperin appears in the appendix.]

Senator BRADLEY. Mr. McCormack?

STATEMENT OF JOHN J. McCORMACK, EXECUTIVE VICE PRESIDENT, TIAA–CREF

Mr. MCCORMACK. Thank you, Senator. Let me just start by saying that I am one of your constituents. I was born and raised, and still live in the Morristown area. It is a pleasure to be here to find that you have an interest in something that I am very interested in.

For over 75 years, TIAA–CREF has served the retirement security needs of the educational community. Today we have 1.6 million educators and staff accumulating and receiving benefits from over 5,200 defined contribution plans.

Senator BRADLEY. Including my wife.

Mr. MCCORMACK. Good.

I am going to comment on employee education and how we feel it is significant to the success of defined contribution plans, and

certainly has, we think, led to the success of the TIAA–CREF program.

Our experience tells us that four key concepts must be communicated to participants in defined contribution plans: start early to take full advantage of the power of compounding; preserve lump sum distributions for retirement rather than spend them; allocate assets carefully to achieve high long-term rates of return; and supplement employer contributions with personal savings.

Many employees learn the importance and the how-to of investing through their employer-sponsored defined contribution plans. The Greenwald/EBRI survey reported that three-fourths of the respondents who had 401(k) plans received educational materials from their employers. Almost all, or 92 percent of them, read the materials. These communications included descriptions of investment options, advantages of tax-deferred savings, and principles of asset allocation and diversification.

Education about retirement savings had an impact on their individual behavior, leading 44 percent of participants to adjust their investment mix, and 35 percent to contribute more to the plan.

Overall, respondents who received and read the educational materials felt more confident about retirement. In order to successfully manage their financial destiny, employees need to overcome both their hesitancy to save and their investment fears. TIAA–CREF believes the key is simplicity; just stick to the basic principles and keep reinforcing them.

To help employees develop their retirement strategies, employers supported by companies providing investments for their plans should communicate a series of retirement savings principles. A recently conducted focus group for TIAA–CREF revealed that employees found the principles approach particularly helpful and simple in confronting retirement planning issues.

Retirement savings principles translate the four key concepts into easy to follow steps. They are: take advantage of what your employer has to offer; remember that Social Security is a foundation to build on; pay yourself first; save with before tax dollars; start early to maximize the power of compounding; diversify your investments; focus on the long-term; keep an eye on expenses and balance risk with reward; leave money for the future; set your goals and review them periodically.

Let me share one example as to how we expand on these goals, and it has to do with the power of compounding. Ann began saving 10 percent of her salary in a tax-deferred annuity each year from age 28 through 35.

Her salary is $27,000 at age 28, increasing each year by 5 percent. Her colleague, Matt, on the other hand, did not begin saving until he was 50. He saved 10 percent of his $60,000 salary, which also increased by 5 percent annually, until he reached age 64.

Who came out ahead? Assuming a 7 percent annual return for both, Ann contributed $103,000 less, but she ended up with almost $30,000 more than Matt had at age 64, thanks to the power of compounding.

In order to achieve an adequate retirement income that will maintain its purchasing power—and we forget a lot about this; inflation occurs not only in the working years, but also in retire-

ment—employees should be covered by defined contribution plans that emphasize the value of participating in investing in equities. Diversifying into equity investments will give individuals a much better chance of hedging against inflation.

In recent years, both plan sponsors and investment providers have made considerable progress in increasing the amount of information they make available on investment options and strategies and, as a result, most employee surveys suggest that most employees between the ages of 25–65 feel knowledgeable when selecting investments.

Employees benefit from both general information about investing, as well as specific details about their investment options under their plans. Information that is tailored to the average level of financial sophistication and that addresses investment flexibility and transfer options is especially useful.

Once employees understand retirement planning and investments, they need a method to measure the success of their saving strategies. They should have a long-range planning tool that allows them to tell where they are in relation to their financial goals.

Retirement income illustrations can help steer employees' perceptions toward viewing their accumulations as retirement funds rather than as a source of immediate funds. Thus, employees will see how far or how near they are to their retirement income goals. Whatever the results, they would be encouraged to save more when necessary and continue to preserve funds for retirement purposes.

TIAA–CREF has long emphasized the importance of asset diversification, along with the historically high rates of return from equity investments. Through our education efforts, over 80 percent of our participants allocate at least some of their assets to the CREF equity accounts. These assets represent half of all the TIAA–CREF combined accumulation.

At the end of 1988, participants in the TIAA–CREF program allocated 58 percent of their contributions to TIAA, and a little over 40 percent to CREF stock account, and 1.5 percent to the newly-introduced CREF money market account.

As of September of 1994, TIAA contributions have dropped to 41 percent, and the total CREF percentage has increased to 59 percent. This four-year period also saw a fairly steady drop in interest rates and a simultaneous rises in stock prices. While some of the shift in allocation was the result of high yields, a large part of the appeal of CREF equity funds can be attributed to the educating we have done by explaining the new investment options.

TIAA–CREF takes its investment education responsibilities quite seriously and we carry them out with a wide range of tools, techniques, and media. Our booklets cover topics such as investment and income options, how to calculate retirement income needs, and a variety of tax issues. These booklets range from pamphlets on single topics to participant newsletters, and special reports on key issues.

We support plan administrators through the Financial Education Series, which are employee seminars covering all phases of retirement planning. We also offer toll-free telephone response centers, one-on-one counseling, and videos. Recently, we introduced interactive financial software to assist participants with their retire-

ment planning and to help them develop individualized model portfolios.

One tool TIAA–CREF uses to show the relationship between retirement income and investment strategies is our annual benefit report, which we send to over one million participants each year. These reports are personalized to reflect individual contributions, investment allocations, and retirement age. They also illustrate estimated monthly retirement income. We also alert participants to the impact of inflation on this report by showing what benefits would be like under an inflation-adapted pay-out option.

In conclusion, I would like to re-emphasize a few key points. Based on TIAA–CREF's more than 75 years of experience, we know that, when combined with Social Security and a reasonable amount of personal savings, a defined contribution pension plan can provide an adequate retirement income.

With adequate education, most employees can be convinced to diversify their allocations appropriately. Education is what is also needed to prevent plan participants from taking and spending lump sum distributions. Finally, increased information is highly helpful in educating and encouraging participants to increases their personal savings.

Senator BRADLEY. Thank you very much, Mr. McCormack.

[The prepared statement of Mr. McCormack appears in the appendix.]

Senator BRADLEY. Dr. Schieber.

STATEMENT OF SYLVESTER J. SCHIEBER, PH.D., VICE PRESIDENT, THE WYATT COMPANY

Dr. SCHIEBER. Thank you, Mr. Chairman, for the opportunity to testify this morning.

I am going to make three points this morning. The first, is that the regulatory environment has reduced pension savings and poses a threat to the security of benefits, especially in defined benefit plans.

Second, we need to do a better job of communicating the need to save to workers who are eligible to participate in employer sponsored savings plans, and to workers who do not currently have plans as well.

And, finally, that there is reason to believe that self-directed investment is not as efficient as professionally managed investment, at least in some cases.

Possibly, the difference in investment efficiency is an education problem. John McCormack's statement suggests that you can make some people more efficient investors, but not all employers are dealing with quite the same population that he is.

In terms of the earlier group that testified, Professor Ghilarducci made a point that when the going gets tough, many employers stop contributing to their defined benefit plans. I would like to suggest that many employers have stopped contributing to their defined benefit plans in recent years because of the regulatory environment which they face.

If you turn to page four in my prepared remarks, there is a figure there, Figure 1. Twenty years ago, most employers that sponsored defined benefit pension plans used an entry age normal fund-

ing method to fund their plan. Under that funding method, the actuary estimated what a constant percent of pay would have to be over a worker's career in order to fund the benefit.

In the early 1980's, the Financial Accounting Standards Board began to consider the accounting for pensions, and in the mid–1980's they came out with a proposal, and ultimately a standard, that employers account for their defined benefit plans using a projected unit credit cost method.

The sloped line in figure 1 shows the projected unit credit accounting method. Basically, under that accounting method the cost of a retirement plan is cheaper for young workers, but the offsetting effect is that it becomes more expensive for older workers. If you think about where the baby boom generation was in the early 1980's and the mid–1980's, it was in the early part of its career.

Now, the accounting rules do not necessarily have any effect on funding. But, if you turn to the next page, what you will see is that substantial numbers of large firms have shifted away from the entry age normal funding method to the projected unit credit funding method over the last 10 years. So, what happened was, the funding process followed the accounting process, for a variety of reasons that I can address if you would like.

To add to the effects of the FASB rules, the Omnibus Budget Reconciliation Act of 1987 changed the way that employers can fund their plans. Under the old rules, an employer could fund up to 100 percent of the projected benefit, taking into account expected pay increases for the remainder of the worker's career.

After OBRA 87, an employer could only fund up to 150 percent of the accrued liability, and the curved line in figure 2 shows the accrual pattern for a hypothetical worker. One hundred and fifty percent of accrued benefit is significantly below the projected benefit during the early part of a worker's career. Again, keep in mind that the baby boom generation was in the early part of their career when these rules were passed.

The problem is, these young workers are going to be getting older and, as they get older, the employers are going to have to start contributing additional moneys to these plans.

In fact, if you go back and you look at the effects of OBRA 87 on larger plans at the time it was passed, we went from about 8 percent of larger plans being fully funded, or at the funding limit, under the old limit, to about 48 percent under the new limits. So, we threw a tremendous number of large employers into contribution holidays. The decline in contributions had nothing to do with "the going getting tough."

The OBRA 93 reductions of the compensation limits that could be considered for funding retirement plans have further exacerbated this problem. Today, for a worker who is 30 years old, or 35 years old, earning as little as $30,000 a year, the funding limits can affect the amount that you can put into the plan. Again, the problem is, that as that worker ages, you have to make up for the contributions you do not make early in the worker's career.

Professor John Shoven, of Stanford University, and I have developed an analysis of the implications of the funding slow downs, and what employers are going to have to contribute to these plans in

order to actually deliver the benefits that are currently being promised by the current structure of the plans.

We estimate that employers would have to move fairly quickly to contributing about 60 percent more, on average, than they are currently contributing and would have to contribute at that level throughout the remaining period of the baby boom generation's lifetime.

In terms of what the effects are on savings, my own impression is that the overwhelming majority of workers did not understand the effects of these shifts in funding behavior. They probably have not altered their own savings behavior in response to the slow down of their pension funding, yet they are at risk of losing benefits. So, what we have likely done in this instance, we have reduced Federal deficits by about 34 cents for every dollar we have lost in baby boom generation savings. That is a fairly substantial loss.

The long-term concern is that many employers are not going to be able to make the additional contributions that their plans will now require and the benefits are going to be truncated. They will terminate the plans and the workers will get less out of the plans than they are anticipating, by looking at current formulas.

There is a great deal of skepticism about the efficiency of these plans in terms of their ability to deliver benefits, and I cite some evidence in the prepared testimony to suggest that the main body of data that we generally look at for policy purposes to evaluate the effectiveness of employer-sponsored plans is highly biased. I find that much of the delivery of benefits that is actually going on is not being reported in our surveys of benefit delivery.

In terms of moving on to the other points in my testimony, I believe employers today need to do a much better job of defining savings targets for workers than they are doing. I think workers can be encouraged to save, and will save if they understand what it is that they really need to do. But, for the most part, in terms of communicating savings programs, we have tended to focus on the tax benefits and not on what their role should be in terms of developing an adequate income.

I think we also need a national savings campaign. People are bombarded day in and day out with the urgency of consuming, consuming cars, consuming trips, consuming all kinds of things. We are not generating an offsetting kind of effect that people should also be saving, and we should be.

In the investment behavior area, I believe there is some evidence—I am not sure it is as widespread or as detailed as it should be—that self-directed investment accounts are not being as efficiently invested as those that are professionally managed. So, I believe maybe an education program is warranted here.

I think there are some workers, though, who now have savings accounts that may never become sophisticated investors, and I am not completely convinced myself that the move to self-directed accounts is necessarily in the best interests of these workers in the long-term.

Thank you very much.

Senator BRADLEY. Thank you very much, Dr. Schieber.

[The prepared statement of Dr. Schieber appears in the appendix.]

Senator BRADLEY. Ms. Teslik?

STATEMENT OF SARAH TESLIK, EXECUTIVE DIRECTOR, COUNCIL OF INSTITUTIONAL INVESTORS

Ms. TESLIK. Thank you. As the last, or next to the last speaker, through a long day of hearings, I know that what you most want to hear from me is that I know next to nothing about savings, and I will be brief. I think most of the issues that are traditionally discussed at hearings like this have been discussed, and I will not attempt to repeat them.

I was thinking as I was coming over here this morning about a poster that I saw in the Library of Congress a few years ago which said, "America, A Nation of Readers." And I have spent the last few years having that poster bump around in my mind, thinking, if there is one thing we are not, it is a Nation of readers.

But, coming over to this hearing this morning, it hit me that if there is one thing we are truly not, it is a Nation of savers. We do not save, we spend. We are terrific at spending, as your first hearing on these subjects addressed. We invent new debt vehicles every day, we do not invent new savings vehicles. That is a problem.

It is a particular problem because of what I call the snake and muskrat problem, which is the aging baby boomer problem. You know what a snake looks like when it swallows a muskrat? The muskrat moves down its body. If you picture the demographic curve sort of moving like that, we are the muskrat, and in about 20 years, we are going to have a problem.

I do not think most people explain the problem very clearly, at least in ways that grab the average American's attention, because you tend to get a few paragraphs of numbers and we all tune out. But the number that really hits me is this: after World War II there were 19 workers for every retiree; when the baby boomers retire there will be just over one. That is a demographic disaster that makes plagues seem minor.

And, unlike almost every other demographic disaster we have ever had in history, we know this one is coming. The ironic thing is, we are doing no more about it than if it were a plague hitting us. Indeed, we are spending, we are not saving. The reason people are not here is everyone is out Christmas shopping. Now, that is the reason we have a problem.

The unfortunate thing—and I suppose I should not say it at a hearing like this, so, of course, I will—is that I am not sure that Congress can come up with any meaningful answer because the Nation, as a whole, does not wish to save and, indeed, wishes to spend and our system is that of an elected representative democracy. If Congress turns around to the public and says, we want to give you fewer services for more dollars because it will be good for you 20 years from now, that is political suicide.

So, every time I hear a proposal for what might be a meaningful public policy alternative to encourage savings, my thought is, if I am a politician and I introduce this, I will not be around in a couple of years.

So, what does that mean you can do, other than conclude this hearing quickly? It seems to me, essentially, what you can do is

trick people. You can try to encourage the average American to want to save, because unless they want to save you are not going to tell them to save, or you can pretend it and you can have hearings, but you will not, in fact, change the possibility that we will have political unrest in 20 years.

How do you convince people to save? I mean, probably the short answer is, beats me. I cannot get people in my office to save, and we are a pension office. I think that in my testimony I suggested one main way. I am not sure that it has a lot of hope, but it is the only one I can come up with.

That is, to the extent that we can change our entire retirement system, forget all the things you hear today which are essentially taking the system the way it is and monkeying with it, we look at the entire system and focus it so that the system is individual-based, so that all of us have our retirement dollars that are our dollars, and we know that they are our dollars, there is a chance we will look at those dollars and say, gosh, they are not enough dollars.

I am now 55 years old, I have $30,000 in my passbook pension account, and that is not going to do me for the next 30 years. There is at least a chance that that would make some people want to save more.

I cannot think of anything else that will cause that because we can all be told there is a dilemma, but unless we see that it is our dilemma and our grocery money, I do not suspect that savings patterns, either legislated or voluntary, will change.

I suggested in my testimony that the most telling evidence that I can think of to suggest we should revamp the whole pension system to one based on individuals, not companies, is that we take care of our bank accounts much differently than we do our pension accounts. If almost any of the games that have been played with respect to pension funds in the past 10 years had been played with respect to bank accounts, there would have been political hell to pay. If you had a system like Social Security, where you put IOUs in instead of real money, and you did that to our bank accounts, we would scream.

If you directed our investments to below market rate performing investments, we would scream. If you made us turn it over to the government, we would scream. Those things happen in a variety of ways in the pension world and nobody screams because we do not view the money as ours, in the first place, and we certainly do not look at it and realize there is not enough for us, the baby boomers, when we retire.

So, the only thing that I can think of that is politically potentially viable that Congress could consider looking at would be to revamp the pension system in such a way that we all view our pension dollars as ours. We know how many there are, we can look at that and realize that there is not enough, and we can, therefore, either voluntarily save more, or tolerate mandatory programs that cause us to save more. The point that goes along with that, which is detailed more in my testimony, is that we would then have to move away from our current system, which is employer-based. I am not sure why we have a—— actually, I know why we have an employer-based system, it is an accident of history. It is the same acci-

dent that has caused us to have our health care plans be employer— based. Yet, it is kind of amusing to think about the fact that most of us have employers who buy our prescriptions, but they do not buy our lawn furniture. I mean, why do they buy the one and not the other? It makes no sense. Why is it that the pension arrangements in this country are tied to employers? I cannot think of a good reason. I know why employers offer pensions, it is to retain employees.

But that fact should tell you something, too, because by and large the policy implications of employers offering pensions are not consistent with the policy desires that Congress ought to have if they want us all to save, because an employer, very rightly, wants to reduce contributions, wants to minimize the amount in the fund, and wants to retain employees, which means they do not want portability.

It means they do not tend to cover lower-paid workers because, as I say in my testimony, the dirty little secret of most defined benefit plans is, while in theory they cover all workers, we all know that the lower paid workers are the ones who move on, so they, in fact, are never covered by pension plans. Their contributions consistently subsidize the wealthier employees, and the company's wealthy employees are the ones who stay 30 years.

Employers know that, and they do it on purpose because lower level employees do not, in fact, care very much about their pensions; they come in and they want to know how many dollars an hour they make.

But it means that you have a pension system that is designed to minimize contributions, to prevent portability, it is designed not to cover the people who need it most, the people are going to need a safety net that we are going to pay for in any event. And it is administratively expensive. I mean, you know how many employers have come to Washington in the last 10 years whining about the administrative costs of pension funds. They are huge. You just heard about it in the last testimony. They are huge, because what you essentially have is a million mini governments, each one collecting contributions, making investments, and tracking employees all over the country to send them pension checks.

I cannot come up with any reason why that makes more sense than any number of other models which are out there, many of which are—interestingly enough, booming in Latin America.

So, I think if there is any big picture set of issues that Congress could look at, if they have a meaningful interest in increasing savings rates—it would be to try to refocus our entire pension system to an individual-based system, not an employer-based system. Wait for the electorate to have some interest in savings themselves, because anything else you do will get you not re-elected. In other words, go to lunch.

Senator BRADLEY. Well, I am glad that you were so subtle. [Laughter.]

Senator BRADLEY. That is why I wanted you to be here today, because I think that you make a very important point, that unless people increase their savings today, there is going to be a major problem tomorrow, particularly as the baby boom generation moves down toward retirement.

[The prepared statement of Sarah Teslik appears in the appendix.]

Senator BRADLEY. Now, if I could, Mr. McCormack, I thought you made several very helpful points. The one point you made about compounding was particularly instructive. It is kind of elementary, but it is not elementary if you do not do it. So, could you go over your example once more that you portrayed? You had a situation where one person began saving at 28 and saved for only 7 years.

Mr. MCCORMACK. Correct. Until 35.

Senator BRADLEY. So that person saved 5 percent of her income from 28 to 35.

Mr. MCCORMACK. $28,000.

Senator BRADLEY. All right. So for 7 years she saved, and then did not save after that. Is that correct?

Mr. MCCORMACK. That is correct. It stopped.

Senator BRADLEY. But kept the money in the account.

Mr. MCCORMACK. At 7 percent interest.

Senator BRADLEY. And then another person, Matt, at age 50, which is 22 years later, saved every year, from 50–64, when he reached retirement.

Mr. MCCORMACK. Correct.

Senator BRADLEY. So, Ann saved a total of $103,000 less——

Mr. MCCORMACK. Less. Right.

Senator BRADLEY. —during her 7 years than Matt did in his 14 years. Is that correct?

Mr. MCCORMACK. That is correct.

Senator BRADLEY. And yet she got $30,000 more at age 64.

Mr. MCCORMACK. She had accumulated $30,000 more.

Senator BRADLEY. She had accumulated $30,000 more.

Mr. MCCORMACK. The power of compounding.

Senator BRADLEY. Well, you know, this is a number that should be a public service announcement on television across America.

Mr. MCCORMACK. Well, I think, actually, I want to support something that Syl said in terms of national savings effort, and you could use compounding as a method for putting forth a national campaign for savings, in fact. I think it could be very, very effective.

Senator BRADLEY. Have you done this with your members?

Mr. MCCORMACK. Yes. We do it in a variety of ways.

I have something that I think that was attached to the testimony. If it was not, we have what we call our compound interest calculator. It shows how interest compounds at given rates over various periods of time. It is a little slide calculator, if you will, which has been very effective.

And, in our presentations before staff groups, we generally include a piece on the power of compounding because of how significant a role it can really play in getting people to adequate income and getting them to participate earlier.

Senator BRADLEY. You also allude to a certain concern about lump sum, and I know that Professor Halperin had a real concern as well about lump sum payments. As you know, as a part of OBRA 93 there is a 20 percent withholding if you do not take your lump sum and put it into an acceptable savings vehicle. What impact do you believe these changes are going to have on retirement

savings? I would like to ask Mr. Halperin and you, Mr. McCormack?

Mr. HALPERIN. Well, I think, hopefully, it will increase it to some extent. But I think you still have the problem that the employee may have the money and have to go find their own savings vehicle to put it into it. As was said in the previous panel, once it is in there, it tends to stay, but the hard part is getting it in there in the first place.

So, while I think the idea that you will have to pay taxes on it will tend to encourage more people to save, I think we should have gone further and required the employer to actually put the money in the individual retirement account and put it up to the employee, at least, to have to go get it. I think that would be far more effective.

Senator BRADLEY. So that any lump sum would not be to the individual, but to the individual's designated savings vehicle?

Mr. HALPERIN. Right.

Senator BRADLEY. Would you include the wide range of options TIAA–CREF gives its members?

Mr. HALPERIN. Well, I think the problem is that you want to minimize the burden on the employer, so I think it is a question of how far we would go. I think I would let the employer choose if the employee does not. If the employee chooses a particular place, then I think the employer can just contribute to that.

Senator BRADLEY. Mr. McCormack?

Mr. MCCORMACK. We have evidence that the 20 percent withholding has, in fact, caused some dollars not to move. Just a point in fact that I think is important. I would not require any employer to roll over money into an IRA automatically because it could end up costing the employee more money. If the dollars are accumulating and there is no penalty for leaving them where they are when terminated occurs, then the individual probably should not roll over, as long as they can maintain control and do not have any penalties for not continuing to contribute.

Senator BRADLEY. That is where you would just leave it in the first place.

Mr. MCCORMACK. Exactly.

Mr. HALPERIN. That would be the best option, I think.

Mr. MCCORMACK. That is truly the best option. And the wide range of investment alternatives that we make available, generally, we do not provide investment products that do not have an investment objective that does not fit a retirement long-term savings objective. So, even though there are seven different accounts, they all should fit into a retirement investment saving objective.

Senator BRADLEY. And people get information about your high growth, third world swing fund how?

Mr. MCCORMACK. We do not have a high growth——

Senator BRADLEY. How is some professor of medieval history supposed to make a decision of whether they want to put it in the swing fund or the bond fund?

Mr. MCCORMACK. Actually, we do not have any swing funds, that I am aware of. They are all pretty——

Senator BRADLEY. Well, I mean, international investment.

Mr. MCCORMACK. Global is the one.

Senator BRADLEY. Global.

Mr. MCCORMACK. Yes. Basically, what we have, I mentioned we are using a diskette now. We have a variety of printed materials where we try and get people to feel comfortable with the risk/reward relationships that the various investment objectives offer, and the diskette is proving to be the most popular in terms of people feeling comfortable with the allocation decisions they are making. We try and get them to respond to a series of questions—not a lot, 10 or 11—and then come to an allocation conclusion. That seems to be working very, very well.

Senator BRADLEY. Dr. Schieber, you said that for every 34 cents that we reduce the deficit by ratcheting down the amount that can be put away, we have lost a dollar in savings for the baby boom generation.

Dr. SCHIEBER. We certainly did in the short-term. The question, I think, in the long-term is, what happens? If those contributions are made up, then there will be nothing lost. But one of the problems we have created is we have lost exactly the same kind of compounding effect within the defined benefit plans that you have in the personal account, and so the employers are going to have to put a lot more into the plans than they would have otherwise. Some employers, undoubtedly, will make those additional contributions. My own impression is, some of them may be at the margin; they will find it too expensive and they will not contribute. So, those will be long-term savings dollars lost.

Senator BRADLEY. On your chart on the accrued benefit contribution on page six, you make the point that for an employer to put money in early does not cost much; to put money in late costs a lot. To what extent do you think this accounts for a lot of people being laid off right before they get to the point where they are going to cost the company a lot more?

Dr. SCHIEBER. Well, that is certainly a concern. It is not just related to pensions. Health insurance gets to be a lot more expensive. I mean, all benefits, for all practical purposes, are related in one way or the other to age. So, it is a cost of workers.

I recently was having a discussion somewhat along these lines with Robert Meyers, the former chief actuary of the Social Security Administration, and he is a strong advocate of employers keeping workers around longer.

I was explaining to him that one of the difficulties is that, rightfully or wrongfully, there is a perception that at some juncture that workers' productivity begins to decline. But we have got a very rigid compensation structure in this society.

Compensation is typically a rising phenomenon over a worker's career. And he said, well, why do we not simply lower the compensation once workers reach their mid 50s or early 60s like they do in Japan? Well, that would be a nice thing for us to do, but it is simply not a possibility or a fact of life in a society such as ours.

So, employers are forced with balancing the cost of these workers and what it is they are contributing to the productive output of the firm. It is not a very pleasant equation, but it is the reality of the nature of our economy.

Senator BRADLEY. If you could simplify the system in any way, what would you do?

Dr. SCHIEBER. Well, in terms of simplification, it seems to me that some of the discrimination rules and problems that employers have to deal with could be made less onerous. I think, though, in terms of funding, we need to raise the limits that we have been lowering over the last 10–12 years.

Senator BRADLEY. Would you agree with that, Mr. Halperin?

Mr. HALPERIN. Well, on the funding proposal that Syl made in his testimony, I agree with him 100 percent. We often disagree on a lot of things, so I suppose there is something to be said for that.

I think, though, in some ways it is more complicated because, in a sense, there are three ways you can think of what a pension plan costs you. It is what the IRS or the Code will allow you to contribute, it is what the accountants say it costs you, and what you think it really costs you in terms of your own budget, and presumably on how it impacts on how much wages you are willing to pay.

What we seem to be saying is, when the Code is changed to limit the amount of contributions, that employers treat that as the cost and, in effect, do not say to themselves, wait a second, Congress made a mistake here on what they allow me to fund, but I know this plan is a lot more expensive and I ought to put the money aside and keep it someplace else.

If that is happening, then the savings does not get reduced, it just does not get the tax benefits. If it is not happening, one wonders about the sophistication of the business community. But, putting that aside, I definitely agree that the funding rules are wrong.

Senator BRADLEY. Dr. Schieber, what would you say about the benefit manager's ability, as you have observed performance?

Dr. SCHIEBER. Well, one of the problems is that the benefit managers, oftentimes, are not the financial drivers in the corporate world. There have been many complaints, in the business media and elsewhere, that some of our corporations take a shorter term perspective on some of these issues than maybe they should. The fact of the matter is, they——

Senator BRADLEY. What does that mean?

Dr. SCHIEBER. What does it mean? It means that they do not necessarily save today for contingencies they are going to be facing in their tax qualified plans, because they cannot make a contribution to the plan today.

Senator BRADLEY. So, corporations make the same mistakes as individuals?

Dr. SCHIEBER. Corporations are being driven very much by the funding limits that they are facing, and they cannot put money into the plan today. It is not easy for them to set up segregated accounts to hold money in escrow for some period of time to, on a belated basis, put into the plan.

Senator BRADLEY. Do you think, Ms. Teslik, that corporations are making the same mistake as individuals, in terms of not saving enough, not contributing enough?

Ms. TESLIK. It is not something on which I am particularly expert. I certainly think that corporations will feel the related pressures that individuals do, among other things, to report to us, their shareholders, that they are being profitable. And, to the extent they incur costs now for benefits later and the returns do not look

as good, they may worry that they will have problems of that nature.

Dr. SCHIEBER. You know, the Tax Code has been telling many employers that the appropriate contribution to their plans in zero, in recent years. Maybe they are not taking good counsel in this case, but they are taking counsel.

Senator BRADLEY. Do you think that making the benefits of compounding, a national education campaign, would help, Ms. Teslik?

Ms. TESLIK. I think that is the kind of thing that has the potential of getting someone's attention. It is almost suggesting free money if you put it aside now rather than 10 years from now. It is the same money, but you will get more out of it. It seems that that kind of message, combined with the message that this is actually your grocery money, might help.

Senator BRADLEY. Yes. Mr. McCormack?

Mr. MCCORMACK. I just want to follow-up on that, because there was a very good point made. There should be a goal as part of the savings campaign, and there should be annual reporting in terms of telling people where they are. And you can marry the concept of individual ownership and institutional sponsorship through the defined contribution plan approach.

Senator BRADLEY. Yes.

Mr. MCCORMACK. In fact, this is what our system does, and, in fact, it has shown itself to work quite well.

Ms. TESLIK. It is the kind of system that a lot of the Latin American countries are adopting in different forms. But, for example, in Chile the system is, everyone has to be in a pension fund, but the pension funds have nothing to do with the employers. There are, say, 20 pension funds in the country, and you have to put your money in one of them. And then you get a book, like a passbook, like we used to have as kids on bank accounts, and it tells you exactly the savings that are yours, and you can move those around anytime you want between pension funds. It has nothing to do with your employer, so it makes it genuine individual ownership and you do not have any of the portability problems or the other assessment problems that you otherwise do.

Senator BRADLEY. Mr. Halperin?

Mr. HALPERIN. I wanted to say something about education. I find, in talking to my colleagues, that most of them have no idea whether they have adequate savings for retirement in a defined contribution plan, and that probably includes me as well.

Senator BRADLEY. Well, let me ask you all this. The Labor Department is talking about a safe harbor plan where they will lay out a system where you tell somebody, you have to report what you would need if you actually had an adequate retirement nest egg, and where you are on that path, given what your company or you are doing. Do you think that kind of approach, that kind of information would be helpful?

Mr. HALPERIN. Yes. I have been advocating something like that for a long time.

Senator BRADLEY. Well, what happened? Why have we not had it?

Mr. HALPERIN. Well, I think employers are reluctant to do it because they feel it sort of turns into a promise, which means when performance is less, the employee may come back 10 years later and say, hey, it is your fault.

I get the statements from TIAA–CREF, but with all this flexibility that we have now—my employer will let me put money in Vanguard and Fidelity as well, and they do not send statements—TIAA–CREF does not know how much money I might have in those others.

So, if the information is going to be helpful, it has got to come from some central place. The only one that would have that would be the employer and not TIAA–CREF. Now, it is troubling that we are sort of saying, let us let the employers take charge of our retirement savings. But I think the fact of life is, we need somebody to tell us where we are, and it is only the employer that has that total information.

Mr. MCCORMACK. The other vendors, the other financial investment vehicles, should be doing the same thing we are doing. They should be required to do it. You should not put the onus on the employer because he probably cannot afford to do it.

Senator BRADLEY. Let me ask each of you, what do you think would be the most effective way to assure that people in businesses under 25 actually get pension coverage, given the fact that only 19 percent of them now have pension coverage? Just go down the list. Tell me what you think, quick.

Dr. SCHIEBER. I guess I am not very sanguine that you are going to get many small employers to set up plans. If you want the people in these firms to have access to more effective tax-qualified savings, that you should have an independent 401(k) or something that the workers could set up.

If you are concerned that the owners of small firms are going to take advantage of it at the expense of not providing benefits to workers in their firms, you could limit the independent 401(k) to people who have only wage incomes. In this fashion, you would sort out people who have business income unless they are willing to set up a tax-qualified plan. That would give more people access.

Senator BRADLEY. Mr. McCormack?

Mr. MCCORMACK. We think that a defined contribution type of an arrangement with some kind of safe harbor rules so that we can take some of the onus of the regulatory issues off the table, with minimum contributions or minimum matched contributions, with obviously certain minimums and with certain maximums, from the employer's standpoint, would do it.

Senator BRADLEY. Ms. Teslik?

Ms. TESLIK. I would not hold out much hope under the current system that there would be any meaningful change in that situation. If it did come, it would certainly be in some kind of defined contribution in simplified form. But, I think unless you are revamping the entire system, that is a group that will not be covered.

Senator BRADLEY. Mr. Halperin?

Mr. HALPERIN. I agree. I think defined benefit plans do not make sense for employees of small business because there is no guarantee the business is going to be around when they retire. It has to

be a defined contribution model. What we need is TIAA–CREF or something similar to it to sell to small business people.

Of course, we thought SEPS might do something, but they do not work, I think, because the employer has to take too much initiative and too much paper work. We need to simplify it, and that is the only way we have a shot. But I am not sure we will get very much.

Senator BRADLEY. Do all of you agree that the fundamental problem is stagnant wages, that if wages had increased, as they had from 1945 to 1975, that there would have been more savings than there have been from 1975 to 1995?

Dr. SCHIEBER. Absolutely. But we have got a little bit of a chicken and an egg problem.

Senator BRADLEY. Well, we will just start with this egg. Do you agree with that?

Dr. SCHIEBER. To an extent, I agree with it. Lower savings are probably the reason it should not be the excuse.

Senator BRADLEY. Mr. McCormack?

Mr. MCCORMACK. Yes, I would agree.

Senator BRADLEY. Ms. Teslik?

Ms. TESLIK. Yes.

Senator BRADLEY. Well, let me thank you all very much for your testimony. This is what I had hoped would be the second of a long series, at least in the first 3 months of the next session. I do not quite know where this is going to head, but I do know Senator Packwood is, himself, interested in this general area.

I think that the numbers compel us to do something about it, particularly given the nature of technological change and the number of people that are being dislocated by that change, and the number of people who are losing their pension rights with their jobs, and the number of firms who are following down-sizing strategies that are calculated not only to saving wages, but to saving benefits, the largest in liability being, of course, the pension benefit liability.

So, this is an area of enormous importance. It also is one that I view as something that would make the S&L crisis small in comparison once it bursts on the scene in the early 21st century, and it is better to do something now rather than be sorry later.

I think that your testimony has at least focused us on a few things. There are a few minimum cost measures that I think that we can take, and I hope that the committee will broaden its view so that we are not always caught in the kind of medieval debate about whether this tax incentive will increase X percent net and savings overall versus personal savings, versus what it loses in governmental savings. There are, I think, other productive ways that we can go as we continue to debate that point. I think this hearing has revealed a couple of those and I think there is a surprising amount of agreement on it among people who I had thought might be a little more in disagreement.

In final comment, we have to realize that all of this, which tends to get all caught up in esoteria and complicated expertise, that the ultimate beneficiary or victim are the people who are were at that table right after Secretary Reich, and their lives are either going to be better by what we do, or they are going to be impaired by what we fail to do. Given that fact, I think our charge is fairly

clear. Your testimony has been very helpful in moving us in that direction. Thank you very much.

[Whereupon, at 12:21 p.m., the hearing was concluded.]

APPENDIX

Additional Material Submitted

Prepared Statement of Hon. Bill Bradley

I would like to welcome all of our distinguished panelists and guests today. This is the second hearing that this subcommittee has held on the critical issues of savings and retirement security. Last June, we met to determine whether the United States was facing a savings crisis. At that time, we noted that the national savings rate had fallen from an average of 7.7% of gross national product in the 35 years up to 1980, to 3% between 1981 and 1993, to less than 2% in 1993. Given the threat that this decline poses for the future economic growth of our nation and the retirement security of its citizens, we concluded that we are indeed facing a savings crisis.

I called today's hearing in order to focus our attention on the consequences of this crisis and to open a dialogue that hopefully will lead to solutions to the crisis. In order to solve this crisis, we will need to attack both the decline in private savings rates and the explosion in public dissavings. For today, however, I hope we can focus on the decline on private savings and the threat it poses to the ability of individuals to live comfortably in their retirement. Unfortunately, all too often, we discuss matters of public urgency without acknowledging the human face associated with each issue. I believe it is vital that our public debate be illuminated by a real world understanding of the impact that these issues have on our families and communities.

Although we know that, as a nation, our private savings rates lag behind those of our main economic competitors, what does this mean for the young New Jersey family that is struggling to make ends meet let alone set a little aside for a rainy day? How about for the older, divorced woman whose only savings come out of her small paycheck as a part-time worker? What do declining private savings rates mean for the construction worker who is forced to move from job to job in order to find steady work and, as a consequence, never stays on one job long enough to vest in a pension plan? Finally, what does it mean for the harried computer consultant fortunate enough to participate in her employer's defined contribution plan, but faced with the daunting (and time consuming) responsibility of investing those funds for retirement?

Each of us, younger, middle-aged, and older, has to deal with the constant struggle between satisfying today's wants and tomorrow's needs. Should you buy new school clothes for your children or set the money aside for their college educations? Should you buy a computer or save for the downpayment on your first house? Unfortunately, with a decade's long drop in real wages, this struggle becomes all the more difficult. Should you borrow against your retirement plan to pay the mortgage or risk losing your home? In this struggle, long-term goals frequently lose out to short-term needs.

Too often, the cumulative effect of these tradeoffs leaves individuals facing retirement with little or no savings. In a 1989 study, the Social Security Administration stated that the median personal savings of retired workers was less than $10,000, excluding housing and car values. Therefore, unless these individuals plan to sell their homes, they will have very little to live on other than their Social Security benefits. Unfortunately, given rising property taxes and other household expenses, many of these individuals will be forced to sell their homes simply because they will no longer be able to afford to live in them.

The risk that individuals will not be able to maintain their living standards as they age is not limited only to those who are already retired. In one recent study, it was estimated that individuals aged 35 to 44 were accumulating assets at only one-third the rate necessary to maintain their living standards in retirement. As a

result, this group of baby boomers will have to either significantly increase their savings rates or suffer lower standards of living as they age. Unfortunately, even when individuals are among the lucky few with substantial retirement savings, they often lack the time and financial expertise to properly manage and invest these assets.

The decline in private savings presents us, as a nation and as individuals, with enormous challenges. The cost of failing to meet these challenges mounts with each passing day. I hope that today's hearing will help us to meet these challenges in a way that satisfies our individual retirement needs and national economic objectives.

PREPARED STATEMENT OF RICHARD DUNN

My name is Richard Dunn. I have been involved in the pension field since 1978, having practiced as an attorney, consultant and benefits expert. Since 1992, I have been GE's Consultant Qualified Benefit Plans, which means that I have the primary responsibility for design of our Pension and Savings plans. These plans total almost $37 billion dollars in assets, but my responsibility does not include investment. The GE Pension plan is a defined benefit plan covering approximately 147,000 active employees—over 450,000 people when one includes retirees and terminated vestees.

There is a certain irony in my testifying regarding the wise use of early retirement programs. As our compatriots in the union movement will no doubt be happy to verify, GE is hardly in the forefront of this area. Just last summer, we spent almost 6 weeks debating with the IUE and UE the merits of various voluntary programs such as "30 and out," the "rule of 85" and their various combinations. I remember well the comment from one local leader: "30 years is young for a tree," he said, "but it is a lifetime on the factory floor." I have not walked a mile in his shoes and take him at his word.

From our point of view, we already have an early retirement feature. Our pension pays out on an unreduced basis at age 60. This is five years before the "normal" retirement specified in our plan and two years before Social Security is available.

We resisted unrestricted voluntary retirement programs and "windows" for three basic reasons:

- The first reason, which is in some ways the reason for this hearing, is that America as a society is going the other way. People are living longer, Social Security will begin later and inflation, while at a 30 year low, remains a fact of life for potential retirees. We believe that these societal factors overwhelmingly encourage later retirement rather than voluntary early retirement.
- Secondly, GE has no interest in subsidizing second careers. One employee, for example, explained to me that early retirement from GE would be ideal for him. It would permit him to work in the same area and the same industry for higher wages, while GE provided the medical and other benefits missing from his new employer's package. In effect, we would be subsidizing our competitor. I realize that this argument is less persuasive in a recessionary economy and can appear insensitive for individuals whose "career" may be limited by education or other circumstances. Nonetheless, we believe that voluntary early retirements tend to overcompensate those individuals who are most employable and most able to seek a second career.
- Finally, early retirement is expensive. Remember most employers provide a bridge called a "Social Security Supplement" between the early retirement age (say, age 55) and age 62 when reduced Social Security benefits begin. An employee who leaves under GE's Special Early Retirement Option, for example, may leave as early as 55. That individual, assuming 30 years of service, receives almost $8,000 a year in supplements in addition to the pension provided under normal provisions of the plan. This $8,000 makes up for the Social Security which will not be paid until age 62 This totals about $55,000 over the seven years in question. This, plus early pension payments, plus medical expenses make early retirement an expensive proposition.

Despite the disadvantages and expenses of early retirement programs, GE has offered a targeted early retirement vehicle since 1988 which I commend to your attention. This program, called Special Early Retirement Option (or "SERO") is to my knowledge, unique in American industry.

The GE pension plan generally provides an unreduced pension at age 60—the major exception to this rule being individuals who qualify for the disability provisions of the plan. For long service employees, (that is, employees at least 55 with at least 25 years of service), our plan offers an important option to take early retirement in the context of certain voluntary job loss events. In the event an individual

is entitled to a SERO election, that individual's pension becomes available in full and includes the supplements discussed above. (We have an entire "safety net" approach extending to medical and life benefits, which are outside the scope of this discussion).

The key point is that SERO requires a job *elimination* to be available. Let me focus on a provision which applies to hourly and non-exempt employees. Under SERO, these employees can in effect "volunteer" to step into the place of another who would otherwise have been laid off in his or her job category. For example, assume that a unit of 20 people will be reduced to 19. Ordinarily, the employee with the least service would be laid off. Our program permits an individual who meets the age and service requirements to step into the place of the less senior employee and take the early retirement. The result? A long service employee, advanced in his or her career, becomes entitled to full retirement and supplements (and may in fact find a second career): A short service employee, at the beginning of his or her career, who would otherwise have been unemployed, now has a job. Please note that we do not develop programs to replace experienced employees with less experienced employees. The SERO eligible employee makes the decision whether a replacement occurs at all. In the above example the employee at 55 years of age is free to continue to work or be unaffected by the layoff. Our view is that SERO in this context is not a choice between working and leisure—it is a choice between unemployment for one employee and a dignified retirement for another.

This SERO program is what Frank Doyle, our Executive Vice President, calls "situational" early retirement. Early retirement under this structure is not the norm, in fact our greatest hope is that our businesses are so successful that no SEROs are required. But SERO is one method by which individuals can deal with the consequences of the structural economic changes on our business.

Is SERO expensive? Absolutely—it costs our pension fund about $100 million additional per year. And a roughly similar cost applies for the medical expenses to which these retirees become entitled. Both our management and employees fully appreciate how important this program is for situations in which individuals have no control over job loss. We are also concerned that early retirement may be only a small player in the total picture of retirement income replacement adequacy. Like most companies, we are trying to find ways to educate our employees that increased job mobility, delayed entitlement to Social Security, increased leisure and longer lives all demand greater personal savings responsibility.

As your committee well knows, ERISA has just reached its 20th "birthday." We all remember the doubts about the passage of the bill, and the dire warnings that no employer would meet the cumbersome restrictions of ERISA.

You may also recall that one of the critical underpinnings of ERISA is the "three legged stool." The idea is that an individual's retirement is made up of three support legs—Social Security, the employer pension and private savings. The explosion of 401K plans and other kinds of savings plans has, we think, added a fourth leg to this stool and one which provides the greatest likelihood of filing in the retirement "hole." An individual cannot depend on a comfortable retirement at any age, unless there is savings beyond Social Security and a company defined benefit plan. I should note here that union advocates have a slightly different view of the subject. Their point is that the individuals most needy for retirement funds are those least able to save due to relatively lower salaries. This point is largely unassailable, but the leg of the stool representing Social Security is far more significant for these individuals.

Our SERO experience is one for you to consider. We make no representation that this program should become national policy. We only know it works for us.

To conclude, GE remains generally opposed to voluntary early retirement programs for our business. But there are situations where early retirement is critical for an appropriate response to the restructuring we see all around us.

PREPARED STATEMENT OF TERESA GHILARDUCCI, PH.D.

Thank you for the opportunity to address your subcommittee and to engage in a serious discussion on ways to raise national personal savings. The first part of my statement addresses how the erosion of employer-proved pensions contributed to the 1980's decline in savings. Additionally, I address how certain types of pension plans promote savings and retirement income security and how public policy can promote institutions that encourage long term savings.

MAIN CAUSES OF THE DECLINE IN PERSONAL SAVINGS

Personal savings in the nation has declined since 1984. The decline in real wages is a main cause of the decline in savings because—according to standard mainstream economics—savings is what is it left of income after consumption. People with lower incomes save at a lower rate than higher income households. Savings rates peaked at 6% of Gross National Product in 1971—1975, just when real earnings peaked. Both have been falling steadily since then.[1]

But real wage decline is not the sole cause of a decline in savings. While real wages fell, institutions that promoted debt expanded and institutions that promote savings for the long term, especially retirement, diminished.

Consumer debt skyrocketed after the 1970s when state and federal constraints on credit diminished. One irony of the recent growth in 401k plans is that households are borrowing to contribute to IRAs and 401k plans. Targeted savings accounts have been partly financed by home equity loans and various forms of consumer debt.[2]

The increase in credit and falling real wages set up a debt environment. But materialism and incapacity to delay gratification may not have caused a large decline in savings. People borrowed to maintain social position. Borrowing of this kind is called "necessity borrowing.[3] Households used credit cards to maintain living standards not to improve them. Given this materialistic culture it is notable that union members have struck, bargained hard, and given up wages for pensions. Ninety percent of union members have pensions.

Employer pensions are institutions that help people save. By 1993, pension plans surpassed commercial banks and savings and loans as the nation's largest financial sector.[4] In the 1980's pension assets accounted for all of the growth in national savings.[5] Pension assets increased mainly because of financial returns. Employers actually reduced pension contributions in the 1980s. However, a significant departure is the increase in union, jointly trusteed, multi-employer pension plan assets. These so-called union plans acted differently than corporate plans. The high financial returns of the 1980s induced some companies to cut back contributions; union plans maintained contributions, improved the finding of their plans and paid out better benefits.[6] Institutions matter, as pension trustees corporations have a conflict of interest and can too easily draw out savings. Jointly-managed (unions) pension trusts are barred from any other use but pension savings and benefits.

Pension contributions, and therefore national savings, declined for two reasons: employers moved away from defined benefit plans and the expansion of pension coverage between 1950 and 1979 came to a halt in the 1980s.

HOW COLLECTIVE INSTITUTIONS PROMOTE SAVINGS

Unions are not just a way workers secure more consumption; unions are important institutions that nurture savings. Pensions were the leading causes of strikes in the 1950s. Workers struck to save. Unions are institutions that help people save for two reasons: collective bargaining educates workers and gives them the vehicle to save. The essential features of a group plan is that is it collective and individual choice is limited. Collective institutions promote social norms that reward deferring wages for retirement.

Interviews with workers and union leaders[7] refuted the notion that pension bargaining caused tension between generations. The reply was that it used to, until young people were educated about the necessity of saving to supplement Social Security. Collective bargaining takes advantage of people's keen interest in their future livelihood. It is a superior educational moment. Bargaining for pensions is a lesson in the importance of saving and thinking long term.

Unions, and public policy that supports them, create collective ways to save. The consumer culture is too strong for people to reduce consumption now for consumption in an uncertain period of retirement later. Where it is collectively rational to save it is irrational individually. People rationally choose, when given the choice, to not save for retirement before they pay for college educations and houses. However, union-negotiated pension plans, and other employer pension plans, are collective enforcers of a savings culture. Social Security is another. These institutions provide ways for people to regulate their consumption. People spend to position themselves in society. People over-consume visible "positioning" items (such as cars, houses, clothes) and under-consume nonvisible items, such as savings and leisure. If everyone is saving together than everyone stays at the same social position. Automatic pensions change social norms to allow for savings and a particular "socially approved" and "socially-sanctioned" consumption level.

Example 1: The Central Pension Plan of the Operating Engineers—as is the case for many multi-employer union plans for workers in the garment, retail and wholesale, coal mining, trucking, longshoring, and other construction trade industries—

is a story about how mobile, lower middle class workers, in seasonal and unstable employment for low capitalized and unstable employers, can create a culture of savings. For forty years this national fund has deducted contributions every hour into a participant's account. This money cannot be withdrawn or borrowed against. The size of the account determines the final benefit. The plan has defined contribution and defined benefit characteristics. It is the best of both worlds.

Example 2: TIAA—CREF, the largest pension plan in the world, is for university teachers and researchers who are upper middle class, highly skilled, and mobile. Both the Operating Engineers plan and TIAA-CREF have similar elements—participants cannot withdraw or borrow against TIAA-CREF accounts.

In contrast to these examples, 401ks plans promise that if a person is disciplined enough he or she will have a pension for life. Such behavior is a stringent requirement on which to base retirement income security and savings.

SIDE BAR

Another example of how political and social institutions can affect savings is lotteries. In Italy, Japan, and other nations, people can save in little chunks by buying small postal bonds. For example, instead of people spending five dollars on a lottery ticket, customers can buy $5 worth of savings bonds. Americans spent over $10 billion in lottery tickets.[8] About 50% went back to people in winnings. Many people buy lottery tickets for the hope of a fantasy pension, a pension for life.[9] If people saved half the amount they spent in lottery tickets—savings rates would have increased significantly by almost 8%.

WHAT POLICY MAKERS CAN DO TO INCREASE LONG TERM SAVINGS

The Limits of 401ks and Financial Education

Increasing incentives for salary reduction plans to spur savings, like IRAs and 401ks, may not greatly increase overall savings for many reasons. Voluntary savings require tax inducements and what is gained in private savings is offset by public dissaving. In addition, voluntary salary reduction plans require thousands of individual choices and decisions, therefore there is a lot of shifting of savings, rather than an increase in savings.[10] Institutionalized, automatic pension plans on the other hand—like union plans—are subject less to shifting. People in real pension plans, in definition benefit plans, actually have higher 401k accounts $14,000 compared to the median amount of $11 in people with only savings plans.11 Institutionalized pensions can actually induce savings . Institutionalized, collective pensions may give more "bang" for the tax-break buck.

There is deep concern that workers invest more conservatively than institutions and the most popular explanation is worker financial illiteracy. A popular response is education. The Department of Labor is launching an initiative to educate workers on the importance of achieving return with more risk and other principles of modern portfolio theory. Educating the American work force to be more productive is a top goal of the Clinton Administration. In the face of desperately needed adult education in basic math skills and worker training in job-specific skill enhancements, especially in the face of new technology, should we spend money encouraging workers to attend Fidelity seminars on derivatives? These activities have a dubious affect on the productive capacity of the U.S.

The flip side of savings is owning shares in the world's corporations. Therefore financial literacy training must come with ownership literacy training. We must teach the three "Rs" of investing and savings—risk, return, and responsibility that comes with ownership. Workers want, and theoretically have, ownership rights to vote proxies and engage management in the ownership of companies. The expansion of savings will come with workers' demands to monitor the very lucrative money management industry. Workers will also want other forms of access to investment decisions. This is a lot of education.

CONCLUSION

Before we spend a lot of money and energy on education we must realize workers may be quite rational and informed in investing conservatively. Instead of assuming workers are stupid, their adverseness to risk may suggest that people are not saving for the long term (when risk-taking is advised), but for more short term goals. More than 50% of the 401k accounts have less than $5,000 in them. When people change jobs, only 20% of people roll over their lump sum transfers to another savings account—80% spend it.

Moreover, there is evidence that 401k's and IRA's are part of the problem of declining savings. They are replacing other pension plans. In 1993, over 75% of 401k and IRA owners viewed their plans as primary plans; this is a substantial increase

over 49.1% in 1988.[12] 401ks may be actually decreasing long term savings. We are the only nation that is moving toward depending on individuals to save for retirement. It is no wonder that we are a nation with stubbornly low savings rates.

It is axiomatic that raising real wages will promote savings rates. Polices that promote wage growth will promote savings—labor law reform, minimum wage laws, international labor standards. These policies alone may not be enough. Public policy will have to address the social and political construction of debt. Institutions must be built up to change social norms that prompt more consumption.

The set of policy alternatives lie along a continuum. At one extreme are feeble voluntary savings plans that will never constitute an adequate response to the retirement crisis. They also cause more problems of income inequality because they only benefit the highest income among us. Twenty six (26%) of those earning $25,000 per year (not just the young) participate in 401ks and have less than $9,000 in their accounts while 60% of those earning $50,000 participate.[13]

In the middle of the continuum, are policies that improve upon existing defined benefit plans but keep some of the essential features of conventional pension plans—savings and insurance features. Social Security is an important component of this tier of retirement savings. Insurance executives fought hard against Social Security in 1934 and 1935. They were pleasantly surprised to find that people actually demanded more insurance products after Social Security's passage because awareness about retirement needs were sparked. On the other extreme are universal and mandatory savings plans.

Savings-promoting institutions are collective and secure. Union multi-employer plans, and professional plans like TIAA-CREF, are prime examples of good hybrids between defined contribution and defined benefit plans. In addition to encouraging the creation of union and union type multiemployer plans in the traditional ways, we could modify 401k plans so that they restrict withdrawals and bring in low income people.

My major point is that worker financial market illiteracy is not the problem and education is not the solution. Shifting responsibility to workers and bullying them from the pulpit to save like professional money managers (they must save 10% to 50% of their income consistently to save enough for retirement) will encourage the high income, not low, to save in individualistic ways, grow up a whole industry of vendors, and divert human activity toward tending to asset allocation and mutual fund performance. There is also the cost of lost opportunities to expand real pension systems that is quite high. For all this cost, national savings may not be enhanced.

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PREPARED STATEMENT OF DANIEL HALPERIN

Mr. Chairman and Members of the Committee: My Name is Daniel Halperin. I am a Professor of Law at Georgetown University Law Center. I have had more than 30 years of experience in the area of private pension plans and employee benefits including in private practice, in government and as an academic. I will discuss the possibility of enhancing retirement security through the use of employer based pension plans.

Our retirement income policy should attempt to foster "full" replacement[1] of pre-retirement income up to moderate levels of income, say up to 150–200% of the Social Security wage base. Full replacement is unlikely to occur unless additional savings are mandated through Social Security or the employer. This seems unlikely at the present time. Nevertheless, I believe that marginal improvements in the coverage of the private pension system are possible.

The Internal Revenue Code provides for favorable treatment of savings in the form of employer-sponsored qualified pension plans. Under a qualified plan, employer contributions are deductible when made, but the employee is not taxed until receipt of pension funds. In addition, the trust fund is not taxed on its earnings. If there is no change in the employee's tax rates over time, this effectively results is no tax on investment income.

I believe that the goal of the special tax treatment for qualified pension plans is enhanced savings for retirement, particularly on behalf of low and moderate income employees, who cannot be expected to save sufficient amounts on their own. Thus, minimal contributions can be made to Individual Retirement Accounts while more generous tax benefits[2] are provided for plans that are said not to discriminate in favor of highly compensated employees, that is plans in which the benefit for non-highly compensated employees is not "too much"[3] less than the benefit for the highly compensated.

Still, despite the tax advantage, it is probable that at least some employees, perhaps primarily those with lower earnings, do not value retirement coverage at its cost, and would resist a reduction in wages intended to finance the plan. Yet, it must be assumed that the goal of the non-discrimination requirements is to achieve coverage for at least some people who would not choose it on their own, even if tax-favored. If this were not the case, the tax incentive could be provided for individual retirement savings. Can this goal be achieved?[4]

There is an obvious dilemma. No employer is required to have a plan. Thus, while favorable tax treatment can encourage the adoption of a plan, the more restrictive the rules, in particular rules which force coverage of employees, who would not save given the choice, the less likely. employers will respond to the incentive. On the other hand, if there were fewer restrictions, such plans that do exist would be less likely to provide coverage to low and moderate earners.

At the present time, only approximately 50% of the work force is covered by employee plans at any one time.[5] While more than 50% will have coverage at some point in their career, it seems likely that, even a number of years from now, as

[1] The meaning of full replacement is complicated. In particular in deciding how much the employee should be expected to save and therefore how much of the replacement could come from savings.

[2] Contrast IRC § 219(b) (maximum $2000 contribution to an Individual Retirement Account (IRA)) with IRC §415(c) ($30,000 contribution allowed to a qualified defined contribution plan. Under §415(b), even higher contributions would be allowed to the extent necessary to provide a "defined benefit" of up to $118,800.

[3] The non-discrimination test permits benefits to be compared as a percentage of pay and also allows a fair amount of disparity between the benefit percentage provided to the highly compensated and that provided to employees who are not in that group. See IRC §410(b).

[4] There are reasons that both employers and employees would prefer that a portion of compensation be deferred to retirement. Employers may hope to both retain workers longer and to facilitate retirement when workers are no longer productive enough to justify the cost of retention. Employees may like forced savings, particularly with the possibility of access to both investment expertise and to annuity contracts at reasonable rates.

This suggests that a substantial portion of existing plans would persist even if the cost of the restrictions imposed outweighed the value of the tax benefits or, indeed, if the tax benefits were reduced or eliminated.

[5] Estimates of pension coverage differ depending upon the data source and the definition used. For a collection of studies, see Pension and Welfare Benefits Administration, U.S. Dep't of Labor, Pension Coverage Issues for the '90s (Richard P. Hinz et. al. eds 1994).

many as one-third of retirees will not receive a pension,[6] and for many the amount of the benefit will be relatively insubstantial. Given the confluence of lower tax rates, tighter limits on benefits per individual and increased restrictions as to coverage, there has to be at least some risk of a decline in coverage.

This level of coverage is troubling in that it suggests the failure of the private pension system to supplement Social Security for a substantial portion of the workforce. There are two reasons for this result. First, the failure of companies, which have plans, to cover 100% of their work force or to provide the same level of benefits for all employees.[7] For example, current law allows employers to disregard part time workers and employees in a bargaining unit. It also permits the high paid to receive a benefit more than 40% higher as a percentage of pay than that accorded the low paid.[8] Thus, less generous plans for lower paid, particularly hourly workers are not at all uncommon. Secondly, and more important, many employers, particularly small employers, have not established qualified plans.

INCREASING COVERAGE IN EXISTING PLANS

Much in the way of pension savings is now consumed prior to retirement. It has become increasingly common to distribute benefits in the form of a lump sum, upon termination of service, and a substantial portion of lump sum distributions are not preserved for retirement. To increase savings for retirement, distributions, not in the form of an annuity, should be required to be made directly to an IRA or governmental account. In addition, special averaging for lump sum distributions should be eliminated and loans and hardship distributions should be limited to unforeseen events. This could increase retirement savings for those who now participate, but what about employees who are never covered.

One possibility is to require qualified plans to cover all employees in a line of business (who have completed a minimal period of service and have attained age 21), whose earnings are below that of any covered employee.[9]

The extent to which such a rule would impinge on the current ability of employers to differentiate in coverage would depend, in part, upon the treatment accorded part time workers and employees in a bargaining unit. At the very least differentiation between salaried and hourly paid workers would be prohibited.

Another issue is the treatment of contributory or elective plans, under which individual employees choose whether to participate or not. Such arrangements would seem to be directly contrary to the goal of universal coverage, except to the extent they play a role in encouraging the adoption of retirement plans by employers, particularly small employers, who would otherwise not put any plan into effect. It is not clear that elective plans can be so narrowly circumscribed.[10]

A requirement that all employees be included in the same plan would result in greater coverage, or an increase in benefits for some who are now covered under less generous plans, only if it could be accomplished without causing a signif icant decline in the number of plans. Note that a decline in plans is a risk even though the suggested rule is undoubtedly simpler than the current non-discrimination tests. While it is often stated that complexity, which increases the costs of compliance, discourages plans, this is not always true. Thus, employers might object to the additional coverage required under the simpler rule. They would prefer the flexibility, and, therefore, the complexity of current law, under which employers are given wide latitude to demonstrate that the plan does not discriminate in favor of higher income employees.

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[6] See Sylvester J. Schieber & Gordon P. Goodfellow, Pension Coverage in America: A Glass Two-Thirds Full or One-Third Empty? in Pension Coverage Issues for the '90s 125, 135–6.

[7] In 1988, 20% of men and 25% of women not covered by a pension plan worked for an employer who already maintained a qualified plan. Sophie M. Korczyk, Gender Issues in Employer Pensions Policy, in Pensions in a Changing Economy (Richard V. Burkhauser and Dallas L. Salisbury eds. 1993) at 65.

[8] The percentage test permits coverage of the low paid at 70% of the level that high paid are covered. The average benefits percentage test requires benefits only 70% as great.

[9] Such a rule could be flexible enough to "grandfather" plans in existence at the time the rule were adopted and plans of an acquired business which differed from the plan of the acquiror. It should also be possible to accommodate preferences by different groups of employees for defined benefit or defined contribution plans. Integration with Social Security could continue to be permissible as long as the (indexed?) replacement rate was at least 70–80% including Social Security.

[10] As now structured, §401(k) plans cannot be used to provide the maximum in tax-favored retirement benefits. This limit furthers the stated goal to some extent. Perhaps other restrictions such as employer size or the existence of other plans could be considered.

ENCOURAGING ADDITIONAL PLANS

One possible means of encouraging additional plans is to increase the tax subsidy. It is awfully difficult to target deserving recipients of an enhanced subsidy, however. Small business is obviously a target but the smallest of businesses, the one person company, already receives an unwarranted subsidy when it provides coverage to its sole owner and employee. The true target must be those employers who have a large number of lower paid in relation to the total size of their workforce. This is the situation where the tax benefits attributable to the higher paid are likely to be insufficient to compensate for a large undervalued contribution on behalf of the lower paid.

A possible approach is to reward employers who provide a significant minimum level of contributions for all employees by allowing them to make additional contributions on behalf of selected employees without regard to discrimination testing. The allowable amount of such additional contributions should be tied to contributions on behalf of non-highly compensated employees. Some suggest elimination or modification of the maximum limits on benefits or contributions might be possible in connection with this approach but I belief this is likely to prove troublesome.

A factor which might discourage plan formation is costs of administration.[11] Ways of minimizing such costs should be sought, for example, by establishing an account for each employee, perhaps under Social Security, to which employers could contribute.

DEFINED BENEFIT PLANS

I believe steps can be taken to reduce the disincentives for defined benefit plans, particularly by phasing in the benefit guarantee to be more consistent with the expected funding cycle (and not necessarily by accelerating funding as is now being done). We should also liberalize the funding rules to allow employers to anticipate increases in both the maximum limits and considered compensation and by eliminating the restriction on accumulation above 150% of the amount needed if the plan terminated. In return we could require benefits payable from a defined benefit plan on separation from service or termination of the plan to reflect future inflation up to the point of retirement.

Since the latter is not required under current law, when a plan terminates, benefits are based upon earnings at that time. Thus, an increase in defined contribution as opposed to defined benefit plans would enhance the benefits of short service as opposed to long service workers. Nevertheless, the growth of defined contribution plans may not have substantially enhanced retirement security if the bulk of preretirement distributions are lost through lump sum benefits which are consumed.

Mandating Coverage

Other Western countries guarantee their elderly population more in the way of retirement income than we do in the United States. If we do believe that as a matter of public policy it is important for people to be able to maintain their standard of living upon retirement, or at least maintain a minimum standard beyond what is provided by Social Security, rather than trying to encourage employer plans or individual savings, it would be more straightforward either to enhance Social Security benefits or require employers to contribute to private plans for their employees.

A number of commentators and President Carter's Commission on Pension Policy have recommended that all employers be required to provide a minimum level of fully vested retirement benefits for all employees. Some may prefer this approach, which builds upon the private system, to improvements in Social Security benefits, because it will result in an accumulation of assets to pay for benefits and increase the overall level of savings. It may be difficult actually to achieve advanced funding of Social Security benefits or to invest sensibly any surplus which is achieved.

Small business, however, has claimed it would increase their cost for labor if they were required to provide retirement coverage. This perception creates a serious political obstacle even though, at least in the long run, it should be possible to reduce wages by required contributions to retirement plans when employees cannot find jobs without this protection. Mandated contributions also could amount to a back door increase in the minimum wage, which could increase employer costs in some

[11] See Donald O. Parsons, Recent Trends in Pension Coverage Rates in Pension Coverage Issues for the '90s 39 at 42–5. (and not necessarily by accelerating funding as is now being done). We should also liberalize the funding rules to allow employers to anticipate increases in both the maximum limits and considered compensation and by eliminating the restriction on accumulation above 150% of the amount needed if the plan terminated. In return we could require benefits payable from a defined benefit plan on separation from service or termination of the plan to reflect future inflation up to the point of retirement.

circumstances. Further, it could be a problem if mandated pension contributions led to a wage reduction. For hard pressed lower income workers additional retirement savings may not necessarily be rational at least at certain points in the life cycle. As was suggested in the case of health care, mandated coverage may have to be accompanied by subsidies to the low income and to small business. Such subsidies may not be easy to justify. In any event, many supporters of more retirement protection found the Commission approach inadequate since it called for a defined contribution plan. While this would be easier to implement than a defined benefit arrangement, it would not help those close to retirement. Others have noted that many of the uncovered workers have relatively short job tenure. Mandated employer contributions would not help this group unless contributions were mandatory immediately upon hiring, an administratively costly requirement. Only Social Security improvements can easily deal with both short service workers and those now nearing retirement. This does not seem feasible at this point.

It has seemed to me that if we view universal participation in retirement plans to supplement the current level of Social Security as an important goal, we would have to recognize that only mandated coverage, either through Social Security or employer plans, is likely to achieve it. Voluntary employer plans and individual savings will always fall substantially short. It may be, however, that there are objections to either approach that make action unlikely. What needs to be faced up to is whether such objections are stronger than the case for universal coverage. We should not fool ourselves into believing that universal coverage is otherwise obtainable.

PREPARED STATEMENT OF JOHN J. MCCORMACK

Good morning. I am executive vice president of Teachers Insurance and Annuity Association and the College Retirement Equities Fund. We are known as TIAA-CREF. For over 75 years TIAA-CREF has served the retirement security needs of the educational community. Today, 1.6 million educators and staff accumulate and receive benefits from over 5,200 defined contribution retirement plans that are funded with TIAA-CREF annuities.

All Americans want a financially secure retirement so they can continue to enjoy the life style they have become accustomed to while working. To achieve this goal, employees must start saving for retirement early since it typically takes about two working years to provide the funds needed for each year of retirement. Yet according to "Survey on Retirement Confidence" by Mathew Greenwald & Associates and the Employee Benefit Research Institute (Greenwald/EBRI Survey), 83% of the respondents acknowledged that most Americans, including themselves, do not save enough money to live comfortably in retirement.

Retirement income has three major sources: Social Security which provides the financial foundation, employer sponsored plans which augment Social Security benefits to generally provide a reasonable standard of living, and savings by individual workers which build retirement income levels up to the desired standard of living. Several years ago the National Association of College and University Business Officers (NACUBO) surveyed retirees of 130 institutions to access how adequate retirement benefits are. Nine in ten retirees reported receiving benefits from social security and 89% reported that they received income from their final employer's pension plan. Income from an employers pension plan provided the largest part of household income for 37% of those retirees surveyed while one-third said Social Security provided the largest portion of retirement income.

The academic community established a standard of adequacy for retirement benefits in the 1950's and has revised it over the years to reflect changes in plan design and the economy. The joint statement issued by the American Association of University Professors (AAUP) and the Association of American Colleges and Universities (AAC&U) recommends an income replacement objective. For those retiring at the normal retirement age who have participated in the plan for at least thirty-five years, retirement plan benefits in conjunction with Social Security should continue after-tax income equivalent in purchasing power to approximately two-thirds of the yearly disposable salary during the last few years of full-time employment. This income replacement benchmark enables employers and participants to evaluate how effective a pension plan is in achieving its goal. Thus, it is not surprising that 77% of the retirees served by NACUBO indicated that their overall financial condition was "about the same" or "better than" when they retired.

By way of background let me make a few comments about the defined contribution plans that TIAA-CREF funds for educational employers.

- TIAA-CREF-funded defined contribution plans provide primary retirement benefits for employees in education and research. The vast majority of these plans specify a contribution rate equal to at least 10% of salary. In the educational community, three variations on primary retirement plan contribution formats exist: first, plans where employers make the full contribution; second, plans where employees and employers share the cost and employee participation is mandatory; and third, plans where they share the cost but employees voluntarily elect to participate in the retirement plan. Educational employers provide meaningful matching benefits of at least 100% of the employees' contributions.
- Defined contribution pension plans effectively provide for a mobile work force, especially as vesting periods have gotten shorter. Retirement funds are preserved and continue to accumulate earnings when employees change jobs, so benefits are not based on frozen final earnings as is typical of a defined benefit plan.
- The investment returns earned on assets accumulated under a defined contribution plan exert significant influence on benefit levels. Over the years, TIAA-CREF has encouraged its participants to diversify retirement savings to include equity investments. Based on historical investment performance, TIAA-CREF participants have generally achieved adequate retirement benefits and maintained their purchasing power.

IMPACT OF EMPLOYEE EDUCATION

In participant-directed defined contribution plans, actual retirement income is critically linked to employee education. One of the first and most important educational goals, especially for voluntary plans, is convincing participants of the need to save enough to ensure an adequate retirement income in the future. Part of the reason for the shortfall in workers' savings is, no doubt, an inability or unwillingness to sacrifice current consumption in order to create an adequate retirement nest egg. But a lack of information on how much employees need to save and how they should invest the funds for maximum advantage also is a contributing factor. Understanding the impact of inflation on the purchasing power of pensions, reinforces the importance of the role that personal savings play in accumulating more substantial retirement funds by increased contributions and diversification into equities. TIAA-CREF encourages participants not only to save for retirement through their employers' basic retirement plans, but, also to save additional funds through tax-deferred annuities (TDAs).

Once employees understand the importance of saving for retirement they can consider which investments to choose. Employees who have a clear understanding of the investment trade-offs between risk and return tend to make investment selections that provide rates of return, which coupled with appropriate savings rates, generate adequate retirement incomes. The adequacy of investment return should not be viewed in isolation, but rather in terms of retirement savings as a whole. We encourage individual participants to think about their pension investments in a broad context which combines Social Security, employer-sponsored retirement plans, and personal savings through 403(b) annuities or 401(k) plans. Thus, achieving a high rate of return on an investment is an important component, but only part of the retirement income security picture.

Our experience highlights that four key concepts must be communicated to participants in defined contribution plans:

- The importance of starting participation early to take full advantage of the power of compounding,
- The importance of preserving accumulations for retirement rather than spending lump sum distributions,
- The importance of carefully allocating assets to achieve a high long-term rate of return, and
- The importance of supplementing employer contributions with personal savings.

For many employees, employer-sponsored pension savings through 401(k) plans and 403(b) plans, for the educational community, is where they learn the importance and the "how to" of investing. The Greenwald/EBRI Survey reported that three-fourths of the respondents who had a 401(k) plan received educational materials from their employers. Almost all (92%) of them read the materials which included: a description of the investment options (95%), the advantages of saving in tax deferred plans (92%), and the principles of asset allocation and diversification (73%). This retirement savings education had an impact on individual behavior, leading 44% of participants to adjust their investment mix and 35% to contribute more to the plan. Overall those who received and read education materials were more confident about retirement.

To successfully manage their financial destiny, workers need to overcome their hesitancy to save and their investment fears. At TIAA-CREF, we believe the key is simplicity—stick to basic principles and keep reinforcing them. Our results in educating participants are positive, with over 80% of our participants putting some portion of their retirement funds into the equity based CREF funds. Finally, employees need a way to determine whether or not they're on the right track—how close their current savings are in alignment with their retirement income goals.

"PRINCIPLES" CONVEY SIMPLE BASICS ABOUT RETIREMENT SAVINGS

Plan sponsors supported by investment providers should communicate a series of retirement saving principles to employees. Focus group research, recently conducted for TIAA-CREF, revealed that employees found "principles" a particularly helpful and simple way to encourage them to focus on the retirement planning issues confronting them.

Retirement Savings Principles translate the four key concepts into easy to follow steps. The following exemplifies how TIAA-CREF might list the principles. We often vary our presentation, by changing wording or focus, depending upon the audience and goal of the publication. (Attachment A)

- TAKE ADVANTAGE OF WHAT YOUR EMPLOYER HAS TO OFFER
- REMEMBER SOCIAL SECURITY IS A FOUNDATION TO BUILD ON
- PAY YOURSELF FIRST
- SAVE WITH BEFORE-TAX DOLLARS
- START EARLY TO MAXIMIZE THE POWER OF COMPOUNDING
- DIVERSIFY YOUR INVESTMENTS
- FOCUS ON THE LONG TERM
- KEEP AN EYE ON EXPENSES
- BALANCE RISK WITH REWARD
- LEAVE THE MONEY FOR THE FUTURE
- SET YOUR GOALS AND REVIEW THEM PERIODICALLY

Let me share an example of how we expand on two of these principles. Educating participants early in their careers, while they can still take full advantage of time to accumulate assets, can significantly close the gap between retirement expectations and ultimate pensions. Because of the power of compounding, even small amounts set aside on a regular basis can produce a substantial retirement income. We provide new participants with a compound interest calculator in our enrollment kits. Also in our *Just Starting Out* "Library Series" publication written for new employees, we offer an effective comparison.

> Anne began saving 10% of her salary in a tax-deferred annuity each year from age 28 to 35. Her salary, $27,000 at age 28, increased each year by 5%.
>
> Matt, on the other hand, didn't begin saving until he was 50. He saved 10% of his $60,000 salary (increasing by 5% annually) until he reached age 64.
>
> Who comes out ahead? Assuming 7% annual investment returns for both, Anne contributed $103,000 less than Matt, but she ended up with $29,075 more than Matt at age 64, thanks to the power of compounding.

Another critical education issue is the importance of leaving the money for retirement purposes. A fundamental advantage of defined contribution plans is portability, which allows a participant to continue building retirement savings even after employment stops. This contrasts with defined benefit plans where benefits, if vested, are frozen at low salary levels especially for younger workers. Some employees who are entitled to pension distributions when they terminate employment take cash and fail to roll over the money. The percentage of distributions used for current consumption is particularly high when employees separate from service early in their careers. Although these distributions are relatively small, they could grow to considerable sums if the funds continue to be invested over the years before retirement. The changes that occurred in 1993 regarding the tax withholding for lump sum distributions from pension plans have increased employee awareness and should have a positive impact on asset preservation.

INVESTMENT EDUCATION

Increasingly sponsors of defined contribution plans recognize the importance of effective employee communications covering allocation of plan assets. The professionals who typically manage assets in defined benefit plans invest a major portion of plan assets in stocks, to take advantage of the considerably higher rate of return of equities over fixed income assets in the long term. Participants in employee-directed defined contribution plans, on the other hand, typically invest a much smaller portion of their accumulation in stocks. In order to assure adequate retirement income that maintains its purchasing power for defined contribution plan partici-

pants, it is important that workers understand the potential value of equities and the benefits of diversification in common stock investments.

Thanks to the combined efforts of plan sponsors and the investment managers, considerable progress has been made in recent years to increase the amount of information on investment options and strategies available to participants in defined contribution plans. The heightened investment knowledge of participants has enhanced their ability to successfully manage their own retirement accounts. Surveys suggest that most employees between the ages of 25 and 65 feel knowledgeable in selecting between investment options within their retirement plan. However, participant allocations to stock accounts are still considerably less than the percentage of assets invested in stocks in the average professionally-managed retirement plans.

Participants benefit from both general information about investing and specific details on the various investment options available under their plan. To be useful, materials should be tailored to the financial sophistication level of the average participant in the plan, and should be correlated with the flexibility of investment options and transfers between funds. For example, a true understanding of market diversification is important. Allocating funds to several growth funds, for example, does not yield the same market diversification as an indexed fund. The increased flow of information poses a risk of making participants so conscious of short-term market movements that they will attempt to market time, rather than staying with a long-term investment strategy that reflects long-term retirement goals. Employees need to fully understand the risks of market timing.

MEASURES OF RETIREMENT SAVINGS SUCCESS

We believe that once defined contribution plan participants have received appropriate education about retirement planning and investments, there must be a method for them to measure the success of their retirement saving strategy. In other words, accumulating participants should have a long-range planning tool that shows were they are in terms of their financial retirement goals.

Retirement income illustrations would counteract the mistaken view of these accumulations as being merely savings. Instead the reports should steer participants' perceptions toward viewing their accumulations as retirement funds. The report should enable participants to convert their accumulations to retirement income. That way participants will see how near—or how far—they are to their retirement income goals. Whatever the result, they will be encouraged to save more and preserve their funds for retirement.

This defined contribution retirement plan reporting would provide more information than most current annual and quarterly reports. While it is not our intention that funding agents should have to create new or additional reports, their current reports should be modified to include income illustrations or projections. While we recognize that reports will vary from provider to provider, we urge that they be consistent enough so that recipients can get a real picture of their total potential retirement income.

RETIREMENT EDUCATION: WHAT WORKS FOR TIAA-CREF

TIAA-CREF has long stressed the importance of asset diversification and the historically higher long-term rate of return from equity investments in its participants education programs. Due in no small part to our education efforts, about 80% of our participants allocate at least some of their assets to the CREF equities funds with a 50/50 split between TIAA and CREF Stock being a typical allocation pattern. Currently, nearly half of all accumulations are invested in the CREF equities funds (Attachment B).

From the introduction of the CREF Stock Account in 1952 until 1988, TIAA-CREF only offered two investment options: TIAA (a traditional annuity) and CREF Stock (a variable annuity). In April 1988, CREF offered participants a Money Market Account and now participants can choose among seven CREF funds. Among today's educational tasks are how to allocate funds between the TIAA traditional annuity and the CREF Bond Market account, both of which include large amounts of bonds in their portfolios, as well as how to use short-term investments held in the CREF Money Market Account. Participants also have to be taught the differences between the CREF Stock, Global Equities, Social Choice, Growth, and Equity Index accounts, all of which are primarily stock accounts.

We think our efforts are paying off. In 1988, participants were allocating 58.3% of their premiums to TIAA, 40.2% to CREF Stock and 1.5% to CREF Money Market. By September 30, 1994, the TIAA portion of total premiums had dropped to 41% and the total CREF percentage was up to 59% (Attachment C). The time period since 1988 also saw a fairly steady drop in interest rates and a simultaneous rise

in stock prices. Hence, at least some of the premium movement was the result of high yields, rather than a change of long-term investment strategy. But we believe that a large part of the reallocation of premiums to CREF results from the educational efforts that accompanied our introduction of the new investment options.

TIAA-CREF takes its investment educational responsibilities seriously. We use a wide variety of tools, techniques and media to carry out our educational efforts. We publish booklets covering topics such as investment and income options, how to calculate retirement income needs and a variety of tax issues. They range in form from single topic pamphlets, to newsletters for participants and administrators, to special reports covering key issues. We offer plan administrators support in explaining their pension plans to employees through the Financial Education Series (employee seminars designed to cover all phases of retirement planning), a number of 800 telephone number response centers, one-on-one counseling and videos. We recently introduced interactive financial software to assist participants with their retirement planning and to help them develop model portfolios.

One tool TIAA-CREF uses to tie together benefit adequacy and investment strategy is our *Annual Annuity Benefit Report,* which we send to over a million participants each year. These reports (Attachment D) are personalized to reflect individual accumulations, investment allocations and projected retirement ages, and to illustrate estimated annual retirement incomes. For our participants, generic illustrations do not cut it. They want to know, "How does this impact my account?" We also alert participants to the impact of inflation by showing benefits under inflation adaptive payout options. After we mailed these reports this winter, we received almost 100,000 calls in March 1994 from participants requesting more information. Thus, clearly one of the benefits of vesting is increased employee awareness because it is something they own.

CONCLUSION

In conclusion, I just want to reemphasize a few key points:

- Based on TIAA-CREF's more than 75 years of experience, we know that when combined with Social Security and a reasonable amount of personal savings, a private pension plan can provide an adequate retirement income,
- With adequate education, most participants can be convinced to diversify their allocations,
- Education is what is needed to prevent participants from consuming lump-sum distributions instead of rolling them over,
- Increased disclosure would be highly helpful in educating participants and encouraging them to increase their personal savings for retirement.

(ATTACHMENT A)

TIAA-CREF RETIREMENT SAVINGS PRINCIPLES

1. TAKE ADVANTAGE OF WHAT YOUR EMPLOYER HAS TO OFFER

Start here. Learn about your employer's retirement plan. When do you become eligible? What investment options are provided? Does it promise benefits based on years employed or does it make regular contributions on your behalf? If your plan matches your contributions, don't pass up this money—it's the retirement deal for your lifetime. But don't stop here. A truly adequate retirement income means you have to save your money, too.

2. REMEMBER SOCIAL SECURITY IS A FOUNDATION TO BUILD ON

Social Security is the base of retirement income for many Americans. But remember it's only of the elements of retirement income. And not only is it not guaranteed but also it may replace less of your income as time goes by. The other elements of retirement income are employer-provided plans and your personal savings. To find out how Social Security figures in your plan, you can check with the Social Security Administration periodically to get a projection of your benefits.

3. PAY YOURSELF FIRST

You earned it. Contribute as much as you can on a regular basis and don't make excuses to avoid saving. Even small consistent amounts can grow into a nest egg that means additional comfort in your retirement. Did you know that retirement equals one-third of a lifetime for many people? So you owe it to yourself to save for that period of your life. Financial planners suggest that for a comfortable retirement you should try to replace at least 70% of your pre-retirement earnings. Abraham Lincoln said, "Prosperity is the fruit of labor. It begins with saving money."

4. SAVE WITH BEFORE-TAX DOLLARS

Make the most of your contributions by saving before-tax dollars. In a 15% federal tax bracket, a $100 contribution monthly means only $85 less in your take-home pay—because the government doesn't collect tax until the money is withdrawn. Before-tax saving through a retirement plan is also convenient because your employer takes the money out of your pay and adjusts your taxable income automatically. So the money you would have paid in taxes goes to work for you between now and your retirement. And remember, you might be in a lower tax bracket when you retire—when you will have to pay taxes on the funds you saved on a before-tax basis. Even if you aren't in a lower bracket you could still come out ahead because of the extra money working for you.

5. START EARLY TO MAXIMIZE THE POWER OF COMPOUNDING

Of course it's never too late to start saving. But the sooner you do start, the harder compounding works for you. For example, $2,000 set aside per year through regular payroll reduction between the ages of 30 and 40 would compound to $116,785 by age 65, assuming a 6% interest rate. At that same interest rate, saving $2,000 annually starting at age 40 until age 65 would compound to $113,263. If you start at age 30 and continue to save $2,000 annually until you're 65, at a 6% interest rate you'll have $230,048. Starting early is ideal; but saving at any point still means more money for your retirement income.

6. DIVERSIFY YOUR INVESTMENTS

Don't put all your eggs in one basket. Study your investment options carefully and learn about their objectives. Diversification reduces risk and helps maintain overall performance; spread your retirement savings among several types of investments (i.e. stocks, bonds, etc.) and diversify within investment types. Remember diversification doesn't mean that you have to invest in a variety of funding vehicles—it can often be achieved with one provider. For example, you can get more diversification in one broad-based stock account than in many narrowly focused accounts of the same type.

7. FOCUS ON THE LONG TERM

Don't react to short-term market swings. Investing over the long term means you'll buy more during market lows—when prices are cheaper—and still have time to ride out ups and downs. For example, stock prices may fluctuate significantly during short-term periods. But over the long term, the stock market has typically outpaced inflation. Remember you're in for the long haul, so you don't have to be conservative—you have time to recover temporary losses. Besides, switching between investment funds for short-term gains is risky.

8. KEEP AN EYE ON EXPENSES

High sales charges, front- or back-end loads, and operating expenses can eat up your returns over time. Make sure you understand how and when expenses are deducted. For example, a cash withdrawal made at the wrong time could wipe out earnings in a plan with a high back-end load. And learn how to make valid comparisons of expenses. Did you know that a real portfolio actually has to earn more than a hypothetical benchmark to match the benchmark's performance? For example, to match the S&P 500 an actual stock fund has to earn more than the S&P 500 to offset the real cost of doing business—a cost that the S&P 500 portfolio doesn't have because as a hypothetical portfolio it doesn't have any real expenses.

9. BALANCE RISK WITH REWARD

The higher the risk, the higher the potential return. You should consider taking some risk, because a return that isn't beating inflation isn't earning you anything. The flip side of the coin is that your retirement funds are crucial to your security during retirement—when your earning power is significantly diminished. So you have to strike the right balance of risk vs. reward that's comfortable for you.

10. LEAVE THE MONEY FOR THE FUTURE

A new car may be tempting, but try to resist cashing out your retirement savings if you switch jobs. If you've taken a loan from your plan, pay it back. If your money can continue to grow in your former employer's plan, leave it there to the extent there are no penalties and you're satisfied with your investment returns. Otherwise you may be better off by rolling it over to an IRA or your new employer's plan. If you do cash out, you will have to pay taxes on the withdrawal and a 10% penalty if you're under age 59½. And remember the cost of a withdrawal also includes the tax-deferred earnings you lose by taking the money now.

11. SET YOUR GOALS AND REVIEW THEM PERIODICALLY

Achieving financial security requires a plan and the discipline to stick to it. Organize yourself. Create milestones. Set priorities. For example, when you enter the workforce in your twenties, your milestone could be to learn about your retirement plan and to start saving—if only a small amount. In your thirties and forties, you might want to renew your investments for their earnings potential and increase your savings amounts. In your fifties and sixties, review your investments for their security. Consider shifting money around to make it more secure. And review your payout options. Decide where, when, and why you want to retire.

(Attachment B)

Deferred Annuity Investment Percentages:
CREF Equity Funds vs. Total TIAA-CREF

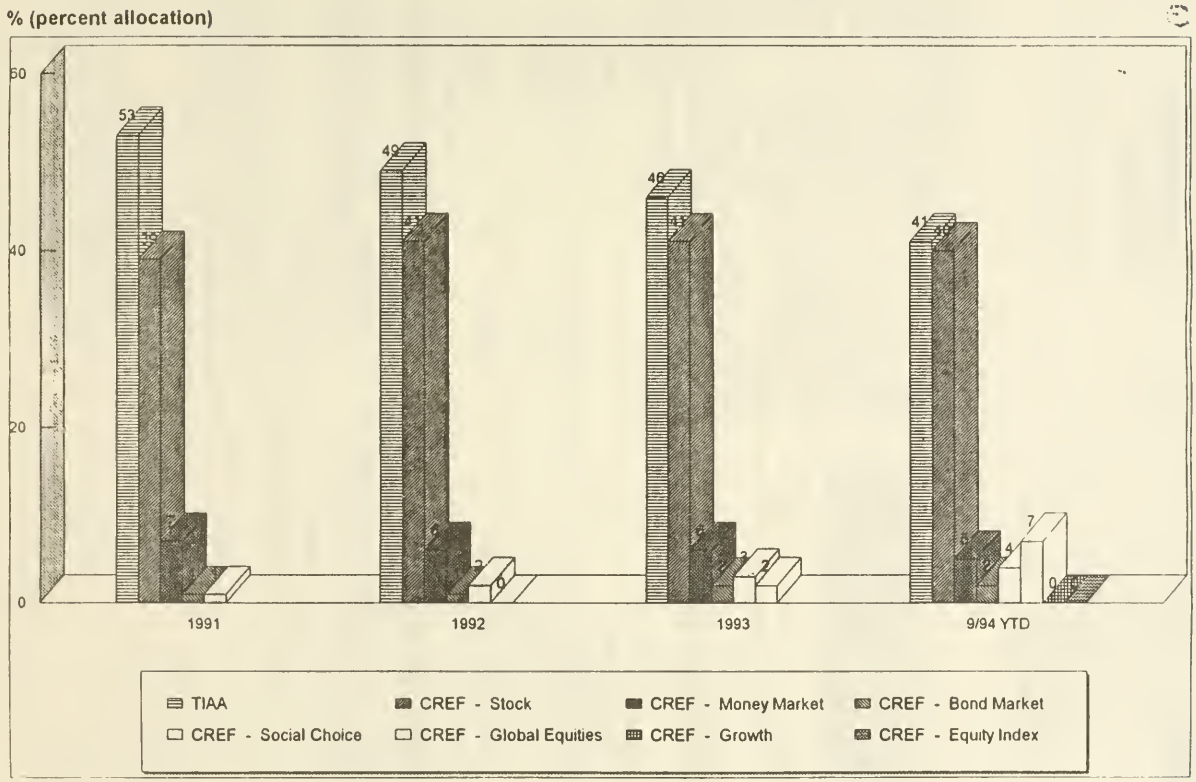
(Based on Accumulation)

	Number of Participants with Accumulation in			Amount of Accumulation		
Age	CREF Equity Funds	Total TIAA-CREF	Pct. in Equity Funds	CREF Equity Funds	Total TIAA-CREF	Pct. in Equity Funds
under 25	11,304	16,595	68%	12,505,272.41	28,575,597.53	44%
25 - 29	55,024	71,151	77%	164,611,651.42	379,813,094.51	43%
30 - 34	109,060	137,756	79%	681,748,874.80	1,548,462,114.43	44%
35 - 39	148,236	186,195	80%	1,736,499,336.16	3,943,638,865.67	44%
40 - 44	179,789	223,852	80%	3,741,886,688.56	8,347,800,866.10	45%
45 - 49	189,356	231,966	82%	6,919,543,584.15	14,382,134,303.17	48%
50 - 54	164,347	198,254	83%	10,558,196,492.16	19,971,652,984.88	53%
55 - 59	118,980	145,430	82%	10,659,941,579.75	19,880,035,464.66	54%
60 - 64	81,495	104,481	78%	8,861,539,922.94	17,558,889,082.30	50%
65 - 69	36,619	50,321	73%	4,541,473,320.18	9,514,331,023.85	48%
70 & over	11,310	17,901	63%	1,368,360,341.72	3,082,974,715.06	44%
Total	1,105,520	1,383,902	80%	49,246,307,064.25	98,638,308,112.16	50%

Note: CREF Equity Funds include Stock, Social Choice, Global Equities, Growth, and Equity Index Accounts

Source: DA Master File (10/31/94)

Allocation of TIAA-CREF Pension Premiums



Teachers Insurance and Annuity Association
College Retirement Equities Fund
730 Third Avenue
New York, NY 10017

(Attachment D)

Annuity Benefits Report

For year ending December 31, 1993
Retirement Annuity

JOHN Q. PUBLIC
2554 MAIN STREET
BUILDING 2600
ANYTOWN, CA. 12345-6789

M01000

TIAA contract number: A123456-7
CREF certificate number: P123456-7
Social Security number: 123-45-6789

If you have questions, call 1 800 842-2776, or write to us.

Total accumulation

	As of Dec. 31, 1992	As of Dec. 31, 1993
TIAA	$29, 964. 98	$35, 579. 44
CREF:		
STOCK	15, 480. 36	16, 745. 72
MONEY MARKET	565. 10	236. 50
SOCIAL CHOICE	8, 624. 18	8, 882. 52
BOND MARKET	6, 070. 57	6, 340. 46
GLOBAL EQUITIES	9, 290. 87	9, 735. 28
CREF TOTAL	$40, 031. 08	$41, 940. 48
TOTAL TIAA+CREF	$69, 996. 06	$77, 519. 92

Illustration of first-year annuity income assuming a rate of return until retirement of 6%*

	If no additional premiums are paid:	If current premiums# continue: see illustration profile section below
TIAA Income		
Standard Method	$11, 455	$20, 982
Graded Method	7, 511	14, 156
Total CREF Income	$8, 873	$15, 557
Total TIAA+CREF Income *Using TIAA Standard Method*	$20, 328	$36, 539
or Total TIAA+CREF Income *Using TIAA Graded Method*	$16, 384	$29, 713

Illustration profile

This illustration is hypothetical and is not guaranteed. It is based on your 1993 year-end accumulation, on an assumed 6% rate of return, and on the following assumptions:*

Your annuity starting age:	65 Years
Annuity starting date:	September 1, 2009
Income option:	One-life annuity with 10-year guaranteed period
Dividends for TIAA payout annuities	1994 dividend scale
#Premiums per year	
TIAA	$2,763
CREF	$2,763

*See reverse side for more information. Actual rates of return may be more or less.

TIAA

Standard Method - your TIAA income includes a contractually guaranteed amount and the entire TIAA dividend as declared for the current year. Income will change if TIAA dividends increase or decrease. Please note that dividends are not guaranteed.

Graded Method - your TIAA income includes the contractually guaranteed amount but only a portion of the dividend. The rest of the dividend is reinvested--in effect, buying additional future income. As a result, payments under this method start out lower but are designed to increase as the years go by.

CREF

Initial CREF annuity income is based on the assumption that CREF will earn 4% a year from the time you begin to receive payments. If CREF earns more than 4%, your next year's income will be higher than the previous year's; if CREF earns less than 4%, your next year's income will be lower than the previous year's.

Premium Assumption

The future yearly premiums assumed in the annuity income illustrations were derived by multiplying the last periodic premium applied to these annuities by the number of times per year that premiums are paid. For example, if premiums are paid on a monthly basis, the last monthly premium applied was multiplied by 12 to determine the annual future premium assumption. If, instead, premiums are paid on a 10-installment basis, then the last monthly premium applied was multiplied by 10.

Illustration of first year annuity income using alternate rates of return

In calculating your first year's annuity income on page 1, we have assumed a 6%* annual rate of return on your accumulations and future premiums. This assumption covers the period from now until your annuity income begins. The table below shows the results if other rates of return were used instead. All other assumptions remain the same. **These illustrations are not guaranteed.**

TIAA annuities contractually guarantee to credit a 3% interest rate (on most contracts), so no estimates are shown in the 0% column.

If current premiums continue, your first year's estimated income is:

(See illustration profile section on front for premium amounts used.)

	Annual rate of return during the accumulation period			
	0%	*3%*	*9%*	*12%*
TIAA Income				
Standard Method	n/a	$14,037	$31,872	$48,888
Graded Method	n/a	9,300	21,758	33,621
Total CREF Income	$6,679	$10,119	$24,122	$37,553
Total TIAA+CREF Income *Using TIAA Standard Method*		**$24,156**	**$55,994**	**$86,441**
or **Total TIAA+CREF Income** *Using TIAA Graded Method*		**$19,419**	**$45,880**	**$71,174**

If no additional premiums are paid, your first year's estimated income is:

Total TIAA+CREF Income *Using TIAA Standard Method*	**$12,189**	**$33,729**	**$55,511**
or **Total TIAA+CREF Income** *Using TIAA Graded Method*	**$9,599**	**$27,569**	**$45,741**

For your information

- You will receive one Annuity Benefits Report for each set of TIAA-CREF annuities you own.
- Your accumulations may be paid as preretirement death benefits. If you die before converting your accumulations to lifetime retirement income (or other benefits permitted by your employer's plan), the accumulations would be payable to your beneficiary under the options available.
- We have the right to correct any clerical errors in this report.
- These annuities do not provide for loans and cannot be assigned.

* Actual rates of return may be more or less. See enclosed insert on "New TIAA Interest Rates/CREF Performance Highlights."

PREPARED STATEMENT OF ROBERT B. REICH

Chairman Bradley, Members of the Committee: Thank you for the opportunity to discuss the state of retirement savings in the United States. The members of this committee have devoted considerable time and attention to this issue. Many of you were instrumental in passing into law last week a bill to shore up the Pension Benefit Guaranty Corporation. I thank you for that—and I applaud your broad commitment to retirement security.

Whether someone is retired or still in the workforce, it's not easy to be middle class in America these days. In the years after World War II—when you, Mr. Chairman, and I—were coming of age, America had a middle class that was the envy of the world. We turned our hard work into homes and cars, health care, and pensions. As the barriers of race and class and gender slowly began to fall, the middle class enlarged still further. Poverty reached an historic low. And the sense of possibility grew stronger.

But then something happened. A global economy made competition more fierce and jobs less certain. Labor unions, once a middle class staple, declined. And new technologies—especially the personal computer—revolutionized the workplace, and eliminated many routine mass production jobs.

As the economy changed, middle class families tried every means of holding on: Spouses went to work, both parents worked longer hours or took multiple jobs, they decided to have fewer kids and have them later, and they drew down their savings. But families have pushed these coping mechanisms about as far as they can go. Our middle class has become an anxious class.

A major source of their anxiety is wages. Last year, even in the thick of a recovery, median household income actually *fell*. And for workers with less education and training, the downward slide has been sharp. Men without college degrees—a group that includes nearly three out of four working men—have suffered a 12 percent *decline* in average real incomes since 1979.

But income and earnings tell only part of the story. Traditionally, membership in the American middle class included not only a job with a steadily increasing income, but a bundle of benefits that came with employment. Once again, we see a widening gap, and once again the gap is related to education and skills. Employer-sponsored health coverage for workers with college degrees has declined only slightly, from 79 percent in 1979 to 76 percent in 1993. But for high school graduates, rates have fallen further: 68 percent to 60 percent over the same period. And rates for high-school dropouts have plunged—from an already low 52 percent in 1979 to only 36 percent last year.

Pensions have followed a similar path. Consider: nearly two out of every three workers with college degrees get pension coverage on the job. More than three out of four high school dropouts *do not*.

Indeed, our very notion of retirement is transforming. When we think of retirement, many of us picture a worker rewarded for a lifetime of service with a gold watch, fond farewells, and a lifetime monthly pension check to add to Social Security benefits. Supplemented by some carefully nurtured personal savings—perhaps in the form of life insurance—these sources of income assured security and leisure in retirement.

That happy picture has been true for many of our parents. And many workers assume that they, too, will live comfortably in retirement without following an especially disciplined course of personal savings during their working years.

Secure retirement—like middle class prosperity itself—is certainly possible. But it's possibly not certain. To be sure, in the twenty years since Congress enacted ERISA, we've made progress in ensuring that more Americans have adequate incomes in retirement. Today, more than 50 million people are earning or receiving employer-provided benefits. The aggregate amount of savings held in our private sector pension plan for workers' retirement has risen more than ten-fold since ERISA became law, from less than $300 billion in 1975 to an estimated $3 trillion today.

Yet we still have a long way to go. For example, only about 45 percent of all current workers participate in a private pension plan. Now, that *average* rate hasn't changed much in the last fifteen years. But averages sometimes obscure important details. After all, Senator Bradley and I have an average height of five-foot-ten.

While the overall *rate* of coverage has bee stable, the *composition* of coverage has changed. As more women have entered the workforce and many barriers to better work have fallen, pension coverage for women has expanded. In 1979, 40 percent of America's full-time working women received pension coverage on the job. By 1993, the figure had climbed to 48 percent. By contrast many men—particularly men with only high school degrees—have had a rougher time in the new economy,

which shows up in the pension data: Fifty-five percent of full-time working men were covered in 1979, but only 51 percent were covered in 1993. In general, those who participate in private pension plans tend to be higher-income, full-time workers at large firms. Only about 17 percent of workers in businesses with fewer than 25 employees are earning pension benefits. Coverage of part time workers is virtually nonexistent.

There's been another change, too, one with broad implications for middle class families. When ERISA was enacted, nine of every ten workers who had pension coverage at work participated in "defined benefit" plans. These traditional pension plans guaranteed a monthly retirement check for life, with the amount of the check based on a predetermined, mutually understood formula typically tied to salary and years of service. Added security for these pensions came from the guarantee provided by the Pension Benefit Guaranty Corporation, the PBGC.

But today only about sixty percent of all plan participants are covered by this type of plan. While large companies are not precipitously dropping defined benefit coverage, workers who previously had no pension coverage and workers who want to supplement their defined benefit coverage are fueling a large shift to "defined contribution" plans. In these arrangements, the individual worker must contribute money to the plan—and then bear the risk of how that money is invested. Of course, these plans offer some advantages over the defined benefit form of pension: direct contribution plans allow individuals to tailor how much money to save from each paycheck, and; they make it easy for today's mobile employees to carry their pension savings from one job to the next. And twenty four percent of all workers now save for retirement through salary-reduction plans at work, up from fifteen percent in 1988.

On the other hand, these plans offer no guarantees as to the amount of the pension at retirement, nor do they guarantee a monthly income for life. They promise only that a participating worker will receive whatever has accumulated in his or her personal pension account at the time of retirement. They require that the worker correctly anticipate saving requirements and investment returns over a lifetime, no small task for even the financially sophisticated. And there is nothing to prevent a worker from consuming his or her savings after leaving a job and receiving a lump sum distribution, an event that in fact occurs far too often. An increasing number of current pension plan participants rely exclusively on defined contribution plans as their only form of employer-provided pension plan.

This shift is one reason our national savings rate has been on a steady decline for two decades. According to the Congressional Budget Office, the net national savings rate, which was at a relatively robust 8.2 percent of GDP during the 1970s, has dropped to a barely visible 1.8 percent as of the early 1990s.

The savings decline has serious implications for America's ability to create jobs and increase incomes over the long term. Two related aspects of this problem concern me most.

First is the effect of low savings on our levels of productivity and investment. Improving living standards for middle class families depends more and more on investing in the things that make our people productive—breakthrough technologies together with cutting edge skills. But our ability to invest in computers, data networks, and software depends in part on how much capital investors can draw from our national savings. Even though we operate in a global economy, where capital washes easily across national borders, savings still tend to be invested close to home. And when meager savings create a shallow investment pool, long-term living standards are at risk.

My second concern is the effect of low savings on the living standards of our workers when they reach retirement age. Americans are enjoying longer life expectancies—and therefore longer retirements—than Americans of previous generations. Today's workers will need unprecedented levels of savings to maintain their living standards during those retirement years. But since workers are now earning less and saving less, they'll *have* less—especially if retirement itself grows longer.

Once again, the middle class shoulders most of the burden. The retirement system is shifting more responsibility for saving to workers at the very moment workers are struggling to maintain their incomes and hold on to their jobs. As wages stagnate, it becomes more difficult to pay this month's bills—let alone to save money for the next century. What's more, many men in their prime working years—their forties and fifties—today are working less or dropping out of the workforce altogether. Many of them are left without a pension and without the means to generate any personal savings.

At the Labor Department, we have encountered far too many cases of ordinary people who have reached the age of 65—and found themselves unprepared. Let me describe one person, whom I'll call Joe.

Joe came to us earlier this year, because he thought somewhere along the line, he must have been cheated. All his life he had been looking forward to the day, two years ago, when he could retire. Yet here he was, at age 67, working part-time at a local fast food outlet, arriving at 6:00 in the morning to prepare breakfast for bleary-eyed commuters.

What happened? After all, Joe had worked nearly every business day of his life since he finished high school. And he had held many good jobs, especially as he got older. But his employer in the early years didn't provide a pension—not that Joe was much concerned about that in his younger days. Later, he held a union job as a truck driver that offered a good pension. But he lost all rights to any benefits when he left his trucking job without having vested. Joe's second child had just been born, and he decided to take a 9-to-5 job that would keep him in town. In the 1970s, Joe finally did earn vested rights with his employer's defined benefit plan. But in the early 1980's, his employer changed to a 401(k) style pension plan. Joe remembers something about his company changing its pension plan, but he wasn't sure about the details at that time. In any event, his children were in college and looking to him for support, so when his company sent him a form asking if he wanted to forego some of his salary and have it placed in a savings plan, he declined. Paying the bills and raising a family was hard enough.

When Joe left his job at age 65, he was making $38,000 a year. Today, he and his wife, who never worked outside the home, receive just over $13,000 a year from Social Security. He also gets $108 each month from the defined benefit plan that he vested in during the 1970s. But the check is not indexed to inflation. On that income, they can't live even by the modest means to which 'they were accustomed. That's why Joe has had to "unretire" and return to the workplace.

What can be done to make retirement work out right for middle class Americans like Joe?

First, we need to ensure that all Americans benefit from a growing economy—higher wages and rising living standards generated by a world-class workforce. We need investment, public and especially private, in our workers' skills, their abilities, and their capacity to work together. This is not a matter of simply *creating* jobs. The economy has added more than five million jobs since January 1993, most in high-paying occupations, and the Administration is justifiably proud of that record. But the 110 million existing jobs continue to split between a relatively few well-paying ones, mostly for well-educated professionals and executives, and a much larger number going nowhere. This is not a matter of simply generating *growth.* Corporate profits soared 45 percent in the last quarter, and productivity grew at an annual rate of 2.7 percent. But wage growth hasn't matched this pace. And this is not simply a matter of increasing overall *wealth.* Between 1983 and 1989, mean household wealth increased 23 percent. But almost all the growth went to the top twenty percent of house holds—and half of the growth went to the *upper one-half of one percent.* The rich got richer, and the very rich very much richer. But the rest of the country either treaded water or sank further, trends that continue today.

The only enduring solution is to equip every American to succeed through hard work—under the rules of the new economy. It used to be enough to keep your shoulder to the wheel and be loyal to your employer. But the rules have changed. Now you need to make your own way in the economy, learn new skills throughout your career, be ready to apply them in new ways and in new settings. That's why this Administration has fought so hard for education, training, skills standards, youth apprenticeships, a reemployment system, and the earned income tax credit.

In the end, the best strategy for increasing savings is to increase *wages*—so that people have something left to save after they've paid the rent, purchased the groceries, bought the kids clothes, and taken care of the health care bills. Sometimes we talk about savings too much in the stern tones of a finger-wagging schoolmaster. We've got to realize that people can't save what they don't have. A growing economy that brings every American along must be an essential element of our savings strategy.

Second, we need to educate Americans about the importance of taking personal responsibility for their retirement security. Equipping workers with the financial capacity to generate retirement savings won't be sufficient if they do not grasp the fundamental importance of following that course. Workers need to be educated on the need to save as much as they can, as early as they can. And much of the burden of educating workers on this reality properly rests with employers.

The data demonstrate that many workers don't have the right knowledge to ensure sound retirement income. For example, participation rates in 401(k) plans—es-

pecially among younger workers—are low. When workers change jobs, an event that presents the worker with a choice between preserving his 401(k) retirement savings and pocketing it immediately, too many still take the latter course. We can take heart that matters seem to be improving. Among workers offered a 401(k) plan, the portion of those electing to participate rose from 60 percent in 1988 to 67 percent last year. But even these numbers are insufficient.

That is why in the coming months, the Labor Department will be undertaking a national pension education program aimed at drawing the attention of American workers to the importance of taking personal responsibility for their retirement security. In other words, we want to reach people like Joe in time so they can take steps themselves towards a better retirement.

As I've travelled the country, people have told me that saving for retirement is an intimidating task, filled with unfamiliar, confusing concepts and language. Many Americans make few or limited provisions for their retirement security during their working years. Many of these workers have either unrealistic expectations of what they can expect from Social Security or were never alerted to the need to save for retirement until it was too late. Even those workers who have made the crucial decision to begin saving for retirement often do not know where to turn for savings and investment advice or education.

Through this public information campaign, and the continued good work of this committee, we hope to revitalize today's middle class—and make their retirements safe, secure, and productive.

Thank you for the opportunity to discuss this subject today.

PREPARED STATEMENT OF SYLVESTER J. SCHIEBER, PH.D.

Mr. Chairman, I am pleased to appear before the Senate Finance Subcommittee on Deficits Debt Management, and Long-Term Growth today to discuss alternatives to enhance savings security and public awareness of savings needs. I am the Director of the Research and Information Center for The Wyatt Company, a human resources consulting firm that has been involved in the design and administration of employer-based retirement programs for many years. In my current capacity, I have been able to undertake a broad range of research on the operations of our retirement system and the role it plays in workers' saving. I am also currently serving on the 1994-1995 Social Security Advisory Council which is looking into the retirement prospects of the baby boom generation. While the Council is particularly focusing on the operations of the Social Security program and the challenges that the baby boom generation will pose, it is also looking much more broadly at retirement savings in general.

In my testimony today I wish to make three points. First, recent accounting regulations and federal budgetary policy have reduced employer contributions to the defined benefit pension system with the net result that they have reduced personal savings in the short run and pose the serious threat that retirement benefits implied by the current system will not be delivered to many of the baby boom workers now expecting to receive such benefits. Second, I believe that we need to improve our communications with workers and the general public about the need to save. Employers could do a much better job of defining meaningful savings targets for workers and thereby increase the likelihood that workers would begin to save at more adequate levels than recent evidence suggests they have been. Additionally, I believe we should undertake a broad public information campaign to encourage higher levels of individual saving in our society. The third point in my testimony focuses on the need for improved worker and public education about appropriate investment decisions.

IMPACT OF PENSION REGULATIONS

Since the early 1980s, there have been a number of changes in the regulatory environment affecting pensions that are jeopardizing the retirement income security of many current workers covered by pensions. Over this period, the government has implemented a number of laws that have gradually chipped away at the tax preferences accorded employer-sponsored retirement plans by limiting the amount employers can set aside in tax-qualified retirement plans. For example, the Tax Equity and Fiscal Responsibility Act (TEFRA) of 1982, as well as the Tax Reform Act of 1986, reduced or froze for a period of time the funding and benefit limits for defined benefit plans and the contribution limits for defined contribution plans. Over the same period, changes in the accounting rules affecting pensions have pushed sponsors of pension plans to alter the funding methods used to set aside money for their defined benefit plans.

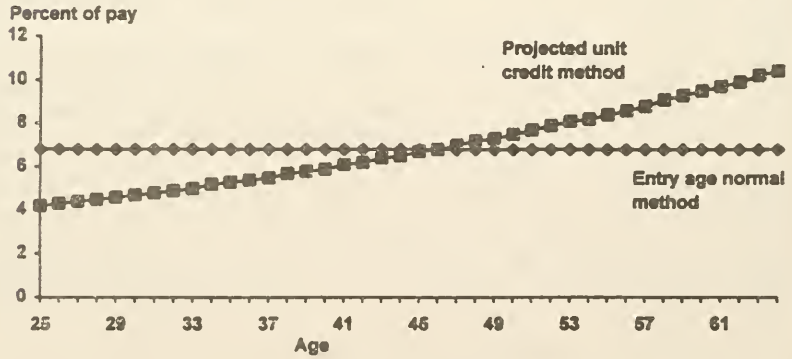
The net result of the changes in the pension regulatory environment over the last dozen years has been a slowing or stalling of the funding of workers' retirement benefits. The risk that the slowdown in pension funding poses is that in the future plan sponsors may not be able to meet the implied promises that their current plans hold out to covered workers. The benefit formulas in many defined benefit plans will require significantly higher future contributions by plan sponsors than they are currently making. These higher contributions are the result of the aging of the work force in combination with reductions in plan funding that sponsors have implemented in response to the changing regulatory environment.

The Watt Company's 1980 *Survey of Actuarial Assumptions and Funding* of plans with more than 1 lives revealed that the majority of defined benefit plans that based benefits on salaries of covered workers-i.e., either final or career average plans-funded the benefit on the basis of the *entry age normal cost method.* Nearly two-thirds of final pay plans used this funding method. Using this method and assuming all actuarial assumptions were met, an employer contributed a steady percentage of a worker's pay over his or her career with the goal of accumulating sufficient resources at retirement to pay expected retirement benefits.

In the early 1980s, the Financial Accounting Standards Board (FASB) began to look at the actuarial methods used for calculating pension obligations and expenses that were reported on plan sponsors' financial statements. FASB ultimately promulgated accounting rules that required that accruing pension benefits be accounted for using the *projected unit credit actuarial cost method.* The differences in terms of the attribution of costs for a hypothetical worker between the two methods are shown in Figure 1. Changing from the entry age normal method of calculating costs to the projected unit credit method results in lower costs early in a worker's career and higher costs later in the worker's career.

Figure 1

Alternative Pension Cost Perspectives for a 25-year Old Worker Over a 40-year Career Under Alternative Actuarial Cost Methods



Source: The Wyatt Company.

While the FASB change in accounting rules was significant from the perspective of reporting pension expenses on financial disclosure documents, the actual funding of plans is carried out in accordance with governmental requirements set out in ERISA. The reason that the FASB rules have become important in the evolving security of current benefits is that they encouraged many plan sponsors, particularly sponsors of final pay plans, to move to a projected unit credit funding method. Table 1 shows that since it became clear that the new accounting rules for pensions would

be adopted we have seen a shift from 10 percent of final pay defined benefit plans being funded on a projected unit credit basis to nearly two-thirds of them being funded that way today. The baby boom generation was in their 20s and 30s as the FASB rules were discussed and ultimately issued. Shifting from an entry age normal funding method to a projected unit credit funding method when such a large cohort of workers were so young slowed down the funding of their retirement benefits. The net effect of this shift toward projected unit credit funding of defined benefit plans has resulted in the delaying of the funding of a portion of the baby boom generation's retirement benefits from the first half of their career to the last half.

Table 1

Percent of Large Final Pay Plans Using Projected Unit Credit Funding Method

Year	Percent of firms
1983	10
1984	19
1985	25
1986	36
1987	44
1988	50
1989	49
1990	52
1991	54
1992	60
1993	63
1994	64

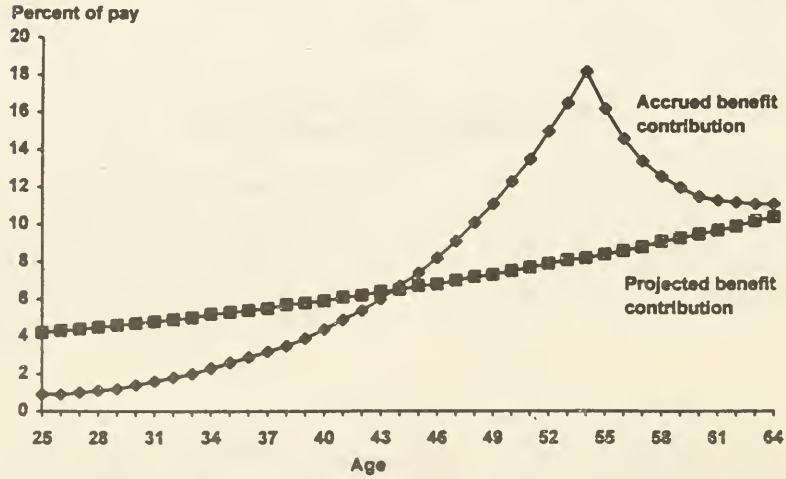
Source: The Wyatt Company

In addition to the FASB rule's effects, the Omnibus Budget Reconciliation Act of 1987 (OBRA 87) reduced the full funding limits for defined benefit plans from 100 percent of ongoing plan liability to the lesser of that value or 150 percent of benefits accrued at the time of each annual valuation. When the funding limit was based solely on the ongoing plan liability, plan sponsors could take into consideration expected pay increases for workers covered by the plan between the time of the annual valuation and their expected date of retirement. In basing the funding limit on benefits that already have been accrued, anticipated pay increases could no longer be considered. Consider the funding pattern that a plan would take for a hypothetical worker if it was using the projected pay increases, as is done in the projected unit credit funding method, in comparison to funding the benefit based on the annual increments in accrued benefits as shown in Figure 2. In the case of a worker beginning a 40-year career job at age 25, the accrued benefit contribution rates would be less than the projected unit credit contribution rates over the first half of the career. Under OBRA 87 the plan sponsor could fund for up to 150 percent of the accrued benefit, but for workers under age 40 in many cases, 150 percent of the accrued benefit was less than 100 percent of the projected benefit. In 1987 when this legislation was passed, the baby boom generation ranged in age from 23 to 41. The Wyatt Company's 1988 *Survey of Actuarial Assumptions and Funding* of pension

plans with more than 1,000 lives estimated that 47 percent of the large plans in the United States would be affected by the new funding limits in OBRA 87.

Figure 2

Alternative Pension Funding Perspectives for a 25-year Old Worker Over a 40-year Career Under Alternative Actuarial Cost Methods



Source: The Wyatt Company

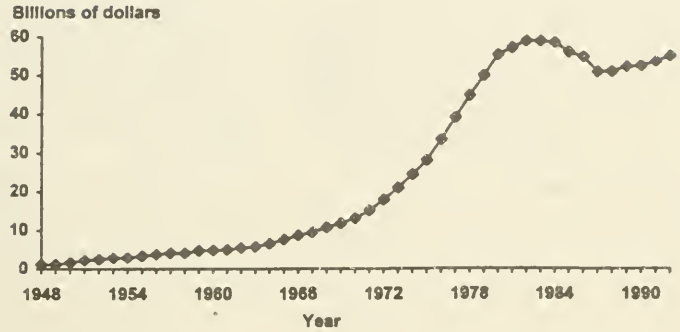
The situation that OBRA 87 created may have been worse in many cases than Figure 2 suggests. Many of the employers that had been contributing to their plans under the entry age normal funding method or the projected unit credit method were thrown into an excess funding position by OBRA 87. Basically this meant that they could not contribute to their plans until the accruing liabilities caught up with the assets that they had put into the plan under the earlier rules. So rather than continuing to contribute to their plans at the rates implied by the accrued benefit contribution line in Figure 2, they enjoyed contribution holidays where their plans required no funding at all for some years.

These contribution holidays created by OBRA 87 ultimately may prove to be a narcotic that will be the death knell for some defined benefit plans. It is one thing for a company to see its annual contributions to its pension program rising by a couple of percentage points from a starting contribution level of 5 or 6 percent of payroll over a decade as its work force ages. It is quite another to have the contribution rate jump from nothing for several years to 7 or 8 percent of payroll. That is the impact OBRA 87 will have on many plans. With such precipitous changes in plan funding requirements, some sponsors simply will not continue to support their plans.

Data on employer contributions to pension plans bear out the impact of pension legislation on contribution levels. Employer contributions to private plans increased gradually throughout the 1970s, but beginning in the 1980s contributions began to decline as shown in Figure 3. Employer contributions in the early 1990s were 15 percent below contribution levels in the early 1980s. Despite the 1974 passage of ERISA—the federal law designed to improve the funding and security of employer-sponsored retirement plans-contributions in 1990, adjusted for inflation, were at the same level they had been in 1970. Per capita contributions, adjusted for inflation, were at the level they had been in the early 1960s.

Figure 3

Employer Contributions to Private Pension and Profit Sharing Plans from 1948 to 1992



Source: U.S. Department of Commerce, *National Income and Product Accounts* for selected years.

Most, if not all, of the legislation adopted since the early 1980s that has limited the funding of private pension plans has been motivated by the desire to reduce the federal government's persistent deficits. These deficits are a serious part of our national savings problem, and I heartily endorse significant reductions in them. Governmental deficit reduction that is financed by reductions in personal savings, however, is unlikely to be effective as a means to increase national savings. The change in the funding limits for defined benefit plans under OBRA 87 had the effect of prohibiting employer contributions to 40 to 50 percent of the large pension plans in this country for some number of years. In many cases, the noncontribution period has extended up to the present time. It is highly inlikely that very many workers undertook increases in their personal savings in order to offset the net effects of OBRA 87, which were to slow down employer contributions to pension plans and possibly jeopardize the long-term security of the promises being held out to workers. If the slow-down in savings through the defined benefit pension system was not matched by an increase in personal savings it had the net effect of reducing our net savings rate during the younger years of the baby boomers' working career. In this case, I strongly suspect that the marginal reductions in the deficit that flowed through the lower deductions of pension contributions by business generated no more than $0.34 in federal deficit reduction for each $1.00 reduction in national savings. This is no way to increase national savings in the short term.

In the long term, it is possible that the reductions in pension saving during the early part of the baby boomers' careers will be offset by increased employer pension contributions during the latter part of their careers. It may be more likely that many defined benefit pension plans will be curtailed as employers come under the pressure of higher costs of delayed saving to make up for the earlier period when contributions were reduced. If employers curtail their pension plans under the burden of higher costs related to the funding slowdown, then the short-term loss in savings flowing out of OBRA 87 will never be made up.

In spite of growing concerns about the baby boomers' retirement security, we see the continuing enactment of laws that affect the funding of tax-qualified retirement plans. Witness the provisions in the Omnibus Budget Reconciliation Act of 1993 (OBRA 93) that reduced the level of individual employee's compensation that can be considered in funding and contributing to tax-qualified plans. The effects of OBRA 93, like OBRA 87, will limit the funding of employer-sponsored retirement

programs. OBRA 93's provisions will further delay the funding of retirement promises from early in workers' careers until later.

In an analysis that Professor John B. Shoven, Dean of the Schools of Humanities and Sciences at Stanford University, and I developed last year, we began to assess the implications of current pension funding policy on the prospects of current benefit promises being kept. In the first part of our analysis, we assumed that employers would continue to contribute to their plans at the same rate they have contributed in recent years but that benefits would continue to accumulate under defined benefit plans in accordance with current benefit formulas. Under this set of assumptions, benefits of the private pension plans will quickly outstrip contributions beginning shortly after the turn of the century. For example, benefits represent 82 percent of contributions in 1994, but by the year 2006, benefits represent 102 percent of contributions, increasing to 163 percent of contributions by the year 2025. The forecast cannot be more clear cut: more funds will be going out of the system than will be coining into the system if things continue as they are today. This potential reversal of fortune will not occur in some far-in-the-future time frame: we estimate the tide may turn as soon as the year 2006, slightly more than a decade away.

Using our baseline set of assumptions that employers would continue to contribute to their retirement plans at the same percent of pay as they do today but that the plans continue to pay benefits in accordance with current formulas, we project that pensions-the major engine of national savings for more than two decades-would cease to be a source of saving by the year 2024. Under these assumptions, we project that the total real saving of the private pension system, projected contributions less benefits plus real inflation-adjusted asset returns, as a percentage of total private payroll would decline gradually for approximately ten years, and then take a far more precipitous downward turn. Whereas, in 1992, real savings of private pensions represented approximately 3.7 percent of payroll, by the year 2040 pensions will represent a negative savings rate of 1.5 percent of payroll, increasing to almost negative 4 percent of payroll by the year 2065.

Under our baseline set of assumptions the defined benefit system would decumulate assets at a rate such that it would deplete all assets in about 2040 leaving behind tremendous residual unfunded liabilities. The funding requirements in ERISA, of course, do not permit such a contingency to arise. As private employers face the prospect that they cannot meet future benefit obligations, ERISA requires that they either contribute additional funds to their plans or that they curtail the benefits being offered under them. Current contribution and accrual rates in the face of the demographic structure of the work force will require that contributions to plans increase or that benefits be curtailed.

There are a number of scenarios that can be considered in terms of employers increasing their contributions to cover accruing benefit obligations. One is that employers would delay increased funding for some time but ultimately would increase defined benefit funding sufficiently to pay the benefits implied by the current benefit structure. Another is that employers would increase their contribution rates in the very near future to a level that would indefinitely sustain private sector defined benefit plans at approximately current levels of funding relative to liabilities. The former strategy would create the risk that when we get to the point that employers have to increase their contributions, they would discover that they were not able or willing to make such a large commitment and then covered workers would have very little time to adjust their personal saving to make up for the cuts in their pension benefits. The latter strategy would require such a large immediate shift in contributions to plans that employers might not be able to adjust other commitments and sustain the plans. It would seem the best strategy that would . . . the risk of benefit reductions would be to gradually increase contributions up to a level that would sustain the systems. We have developed a series of simulations to test these alternative approaches.

In recent years, private employer contributions to defined benefit plans have averaged about 2.8 percent of private sector payroll-n.b., this is all private sector pay, not just pay in covered employment. In what we consider to be the most likely scenario that would have employers remaining committed to their defined benefit plans we assumed that contributions would begin to rise in 1995, increasing at a rate of 0.015 percent of payroll per year until the contribution rate equaled 4.5 percent of payroll. Under these assumptions, the assets in defined benefit plans would remain at a relatively constant level in comparison to payroll over the 75-year projection period. Under this scenario, the private sector defined benefit pension system would have assets to pay benefits until the baby boom generation has completely passed on. In 2065, assets relative to payroll would be down about 4 percent from the current ratio and would be declining ever so slightly. In other words, this funding scenario would get private sector defined benefit plans through the baby boomers' re-

tirement period and would be roughly sufficient to last indefinitely beyond that. Over almost all of the projection period, however, employer contributions under this scenario would be 60 percent higher as a percent of pay than they are today. The alternative is reduced benefits.

It is clear that in the not-too-distant future corporate pension plans will face the tough choice of higher contribution costs or lower pension benefits, exactly the same prospect now facing the Social Security program. What will make this choice even more difficult is that many employers may have become all too accustomed to the low contributions they have made to defined benefit plans in recent years as a result of the changing regulatory environment. These low contribution rates are not going to be sustainable because the aging of the work force is inevitable and the regulatory effects reducing early contributions to the baby boomers retirement accruals has already been realized. In addition, it is highly likely that the high rates of return in the asset markets that retirement plan sponsors have realized over the last decade will moderate. When all of the forces converge, employers may choose to cut back benefits rather than increase contribution levels. What is particularly troubling is the possibility that the funding shortfalls of Social Security and employer-sponsored plans will occur simultaneously, forcing both systems to pare down promised benefits. That would leave the baby boomers in an extremely tenuous financial position as they enter their golden years.

While much of the adverse pension legislation that has evolved over the past dozen or so years has been the result of attempts to reconcile the federal budget deficits, there often has been another motivation behind these legislative efforts as well. There is a general perception on the part of policy makers that employer-based retirement programs have not been nearly as effective in reaching out to workers as many policy analysts believe that they should be. The evidence regularly developed from the *Current Population Survey* (CPS) done by the Bureau of the Census for the Department of Labor suggests that only about half of the work force is covered by a pension. Also from the CPS we know that in 1990, only 44 percent of the elderly over the age of 65 received a pension or annuity income and that the benefits from these programs accounted for only 18 percent of the elderly's income. Indeed, the elderly received as much of their income from wages as they did from pensions, and their pension income was only half what they received from Social Security.[1] The CPS is used widely as a policy analytic tool, and consistently the analyses based on the CPS suggest that employer-sponsored retirement benefits may not be a very secure element of the retirement income security portfolio of many workers or retirees. But, there is convincing evidence that the CPS is significantly underestimating the economic benefits that employer-sponsored retirement programs are providing to workers or retirees.

For example, during April 1993, the Census Bureau conducted a survey of workers' participation in employer-sponsored retirement plans as part of its regular *Current Population Survey* cycle. The April 1993 supplemental questions on retirement plans were directed at workers over the age of 16 in the sample households. Respondents were asked if their employer sponsored a retirement plan or plans, and if so, if they participated in it or them. If they indicated yes to the latter question they were asked whether the plans were of the type where 4your benefit is defined by a formula usually involving your earnings and years on the job" or whether they were of the type where in money is accumulated in an individual account for you."[2] If the respondent indicated they were included in a defined benefit formula plan" or the individual account" type plane they were asked in how many of each type they were included. In addition, respondents could indicate if they were covered in some other type of plan, or that they were included but did not know the type of plan in which they were participating. Our tabulations of the April 1993 CPS data, found that respondents to the survey who indicated that they were covered by both a defined benefit and defined contribution plan sponsored by their employer represented 6.2 million workers. Yet, U.S. Department of Labor analysis of Form 5500 disclosure forms suggests that nearly 14 million private sector nonagricultural wage and salary workers were covered by both types of plans based on the 1990 plan year filings.[3]

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[1] Susan Grad, *Income of the Population 55 and Older, 1990,* U.S. Department of Health and Human Services, Social Security Administration (Washington, D.C.: U.S. Government Printing Office, 1992).

[2] U.S. Department of Commerce, Bureau of the Census, *Current Population Survey* (Form CPS–1, April 1993), question 42.

[3] Office of Research and Economic Analysis, U.S. Department of Labor, *Private Pension Plan Bulletin* (Washington, D.C.: Department of Labor, Summer 1993), no. 2, p. 6.

On the benefit front, the *National Income and Product Accounts* (NIPA) developed by the Bureau of Economic Analysis based on administrative and disclosure data suggest that pensions are paying benefits that are equivalent to those being paid by Social Security. In 1990, the NIPA estimates indicate that the benefits paid by federal retiree programs were $53.9 billion; those paid by state and local government retiree programs were $40.6 billion; and those paid by private pension and profit sharing plans were $148.8 billion. In aggregate, employer-sponsored retirement programs paid out $243.3 billion during 1990. According to the NIPA data, OASDI paid out $244.1 billion in benefits during 1990.[4] In other words, during 1990 employer-sponsored retirement plans paid out benefits that were almost precisely equal to Social Security benefits. Yet the CPS suggests that retirees over age 65 are only getting half as much from these plans as from Social Security.

The problem in reconciling the discrepancy between the NIPA and CPS pension estimates is that there is no large administrative data source that captures total income and its components for the whole population. The closest thing to it is the Internal Revenue Service's Annual Tax Files, which are part of the Statistics of Income (SOD files that the IRS develops for research purposes. These files, which have been produced since 1960 and which we will refer to as the IRS Tax File, are an annual sample of tax filer records that have had all personal identification information deleted. The primary purpose of these files is to simulate the revenue and administrative impact of tax law changes and to provide general statistical information on the sources of income and taxes paid by individuals. One problem with the IRS Tax Files is that there is hardly any information in them that describes the characteristics of tax filers other than the financial information that relates to the filing of federal income taxes. Another problem is that below certain income levels, potential tax filing units are not required to file income tax statements with the IRS and thus the Tax Files do not cover the lowest income segments of the population.

Despite its drawbacks, the IRS Tax Files may be a better indicator of the level of pension payments from employer-sponsored plans than any other potential source of such information. If pensions contribute to retirement income security, people receiving a pension in retirement should, on average, have higher levels of income than people who do not. Of course, higher levels of income trigger the responsibility to file a tax return and filing is enforced by the threat of potential fines and even imprisonment for the failure to file id to do so accurately. In addition, in the past, individuals who received retirement annuities during 1990, as an example, received a Form W–2P in early 1991 stating the amount of annuities they received during 1990 to help in the accurate reporting of income for the purposes of filing tax returns. Also, although the IRS Tax File has little personal information on tax filers it does include information on whether the filer and spouse, if there was one, was over age 65 or blind. The coding of this information is such that filing units where there was a person over age 65 can be identified as long as that person was not also blind. Blind filers over age 65 cannot be separated from younger blind filers. In addition to information on annuity income, the IRS Tax Files also provide information on a host of other income categories.

Table 2 compares the reporting of pension and annuity income, including income paid out of IRA accounts, from the March 1991 *Current Population Survey* and from the IRS 1990 Tax File. Both data sets cover calendar year 1990. The population in each case is split into 10 equal-sized groups (i.e., deciles) based on their 1990 income. Using the CPS, the population was distributed on the basis of total reported income in the survey. With the 1990 Tax Files, the filing population was distributed on the basis of adjusted gross income. While the 1990 Tax Files use a different measure of income than the CPS and do not include low-income elderly units, the income deciles have somewhat more correspondence across the two data sets than one might expect, especially at the bottom and top of the scales. From the CPS, we estimate there were 18.6 million elderly units consisting of single persons living alone or couples where at least one of the two was over age 65 during 1990.[5] From the Tax Files we estimate that there were 13.5 million filing units where a person

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[4] Bureau of Economic Analysis, U.S. Department of Commerce, *Survey of Current Business,* July 1994, Vol. 74, no. 7 (Washington, D.C.: U.S. Department of Commerce, Bureau of Economic Analysis, 1994), pp. 77 and 92.

[5] Note this is a slightly different definition of filing unit than Susan Grad used in developing the information reported in Tables 16.11 and 16.12. In her work, Grad also included people over 65 who were living in extended family arrangements where the elderly person was not the head of the family unit or married to the head of the family unit. She also considered the income available to other members of the family unit in these cases as providing support to the elderly person in the extended family.

Table 2

Prevalence and Level of Pension Income by Income Decile for Single Persons and Couples over Age 65 during 1990 as Computed from the *Current Population Survey* and the IRS 1990 Tax Files

	Current Population Survey			IRS 1990 Tax File		
Income Decile	Income Range	Percent with Pension Income	Mean Pension Income	Income Range	Percent with Pension Income	Mean Pension Income
1	$0 - $6,960	7.8	$2,001	$0 - $6,053	44.6	$2,580
2	$6,961 - $10,795	23.0	2,610	$6,054 - $8,530	59.7	4,452
3	$10,796 - $14,400	33.0	3,756	$8,531 - $10,930	61.2	5,701
4	$14,401 - $18,000	45.7	5,005	$10,931 - $13,520	71.3	6,619
5	$18,001 - $22,016	48.0	6,215	$13521 - $16,785	78.3	7,842
6	$22,017 - $27,000	50.2	7,896	$16,786 - $20,530	75.9	10,169
7	$27,001 - $33,000	53.2	9,445	$20,531 - $27,025	79.5	10,981
8	$33,001 - $41,500	53.4	11,830	$27,026 - $38,041	76.3	13,368
9	$41,501 - $57,887	50.6	14,920	$38,042 - $56,641	73.3	18,091
10	$57,888 +	53.1	20,924	$56,642 +	71.1	35,487
Total		41.8	$9,860		69.1	$12,054
Total Reporting Units		18.6 million			13.5 million	
Total Pension Units		$ 76.5 billion			$ 112.1 billion	

Source: Author's tabulations of the March 1991 *Current Population Survey* and the IRS 1990 Tax Files.

over age 65 was part of the unit. In other words, roughly 73 percent of the potential tax filing inlets with a person over aged 65 filed a tax return in 1990.

In virtually every income decile shown in Table 2, the prevalence of pension or annuity income is significantly higher in the Tax Files than in the CPS. If you assume that most people in the bottom three deciles of the CPS population would not be represented in the tax filing population because of their low incomes, the pension and annuity recipiency rate at the bottom end of the income distributions might be somewhat closer than the table suggests. But at the middle- and upper-income ranges the income tax filing data suggests that pension and annuity receipt is far more widespread than the CPS evidence would lead us to believe. Indeed, the total pension and annuity income going to elderly units based on estimates from the tax files is 47 percent higher than the estimate based on CPS reporting even though there are 27 percent fewer elderly units represented in the tax files.

In a separate tabulation not presented here, the respondents in the CPS representing the 5.1 million aged units with the lowest reported incomes because we assumed that they would be the least likely to have filed income tax returns for 1990. By deleting 27 percent of the aged Units in the CPS file, we were dealing with

two samples that were the same size. By doing so, we deleted slightly more than one million pension receiving units or 13 percent of all of the units that reported they received a pension during 1990. Eliminating these low-income units, however, only reduced the aggregate estimate of pension income paid to the over 65 population by 3.8 percent. At this level the CPS aggregate pension income was 52 percent below that reported in the 1990 Tax Files.

In another set of tabulations we estimated the total pension and annuity income paid to all individuals in the two data sets that we used for this analysis. These tabulations included the payments being made to individuals who had not yet reached age 65 as well as those who had. In this case the CPS file generated aggregate estimated pension and annuity payments of $157.0 billion for 1990 compared with $231.9 billion from the IRS Tax Files. The tax file estimate is much closer to the NIPA estimate of $243.3 billion cited earlier than is the CPS estimate. One would expect the Tax Files to provide a lower estimate of total pension benefits paid in any year than a comprehensive measure of pension income because there will always be some pension beneficiaries whose incomes are low enough that they are not required to file an income tax return. The bottom line here is that the *Current Population Survey,* which is widely used for retirement policy analytic purposes, is significantly underreporting the actual provision of retirement benefits by the employer-based pension system.

While there is strong evidence that the retirement system is performing better than the CPS suggests, the analysis of the income prospects of future retirees under current policies still gives rise to significant concerns. We know that the current financing situation facing the Social Security program in the United States today portends that taxes will have to be increased significantly, benefits will have to be reduced significantly, or some combination of the two will have to occur if the program is to be financially viable as a retirement resource for the baby boom generation. If Social Security benefits are reduced, either employer-sponsored benefits or personal savings will have to be increased or the level of benefits suggested by this analysis cannot be achieved.

The aging of the baby boom generation also portends that the cost of defined benefit plans will increase significantly for many employers as we proceed through this decade and into the next century.[6] Some employers will continue to support their defined benefit plans despite rising costs but some, undoubtedly, will not. If there are substantial curtailments of the plans now offered to workers, many workers in midcareer today will not realize the level of benefit generosity that the analysis here suggests the system is currently offering. If employer benefits from defined benefit plans are curtailed for the same workers that are threatened with Social Security reductions, the imperative challenge of personal savings will be accentuated. In other words, the current system is holding out a respectable promise to current workers, but there is some substantial probability those promises will not be kept.

CHANGING PERSPECTIVES AND CHANGING WORKERS' SAVINGS BEHAVIOR

Economists, using life-cycle models of consumption and savings and factoring in programs such as Social Security and employer pensions, have been able to estimate savings paths that workers should follow in order to accumulate sufficient retirement wealth to meet their retirement needs. Actuaries and retirement plan designers have developed earnings replacement models to aid in the design of retirement programs that allow workers to achieve the goal of having sufficient retirement income to maintain preretirement disposable income levels. While most workers undoubtedly would like to accumulate sufficient resources during their working lives to assure that their standards of living will not decline during their retirement, it is unlikely that the majority of them use the kinds of sophisticated models that economists and retirement plan experts have devised to estimate the level of savings required to meet that goal. Yet when we look at retirees today, it is clear that the majority of them have been able to make sufficient provision for their retirement needs.

In most cases workers likely plan for their own retirement by observing the effectiveness of the retirement accumulation of people that they know and with whom they work. From observing their parents or grandparents they develop a perception of the level of benefits that Social Security provides to retirees. From observing fellow workers who reach retirement and from materials their employers provide them, they develop a perception of the level of benefits that they can expect from their pension programs. From periodic benefit statements they receive from their

[6] See Laurene A. Graig and Sylvester J. Schieber, *The Sleeping Giant Awakens: Retirement in the 21st Century* (Washington, D.C.: The Wyatt Company, 1994).

employer, they see the accumulating balance in retirement savings plans and can make rough projections of the level of savings they can ultimately accumulate by continued participation in them. As they observe that the generations of workers in front of them achieve adequate retirement income levels to meet their needs, they can gauge that their own continued participation in the portfolio of retirement programs they have available will allow them to achieve comparably adequate retirement income levels.

Until now, sophisticated calculations by the economists and actuaries have not been necessary for many workers to adequately prepare for retirement in an environment where the retirement programs in which they have participated have performed comparably, or in many cases have improved, from one generation to the next. The problem that the baby boom generation is facing today is that various elements of the retirement income security system are not likely to perform for them in the same fashion that they have for the earlier generations of workers that they have been observing. Taking into consideration where they are in the wage spectrum, the baby boom workers are likely to face earnings replacement rates from Social Security that are significantly below those that their parents experienced. In addition, because of the future increased cost of pensions, many of the workers currently participating in defined benefit pension plans are likely to receive lower replacement of their preretirement wages from their pension than workers who are currently transitioning into retirement. Also, the gradual shift from noncontributory defined benefit plans to contributory defined contribution plans in recent years means that more of today's workers are personally responsible for their own retirement savings than earlier generations of workers were.

Given the relatively low personal savings rates that prevail in our economy today and the prospects that the baby boom workers could see a reduction in the level of benefits they will receive from organized retirement programs, now is the time to begin to alert the boomers that they have some options to control their own retirement destinies. In order to do so, however, they must increase their own personal savings rates immediately and sustain those higher rates until they retire. Expecting them to do so without communicating to them the sense of urgency for increased saving on their part will likely result continuing low levels of personal and national savings, and ultimately in their failure to reach satisfactory retirement goals. Now would be an opportune time to undertake a variety of organized communication programs that will help to educate workers as to their personal responsibilities in saving for their retirement and their possible exposure for not doing so. Such communications programs should be carried out at two levels.

More vigorous communications by employers who are already sponsoring retirement savings programs would potentially enhance the effectiveness of those programs. These employers have already shown a commitment to the provision of savings opportunities for workers. In most cases, the employer sponsors of these savings plans are already communicating with workers periodically, urging them to take advantage of the tax incentives supporting these plans and the supplemental subsidies that are often available in the plans. Expanding such communications to be more specific about savings targets for workers at various points in the wage spectrum would improve workers' understanding of their role in preparing for retirement and increase the probability that they would come closer to meeting their retirement income targets by the age at which they wish to retire. Even if workers did not respond to the more specific savings goals such communications would provide, they would have a better understanding of the implications of failing to save than they do now.

In addition to increased and more effective communications at the individual employer plan level, I believe it is time to undertake a broad public information program encouraging personal savings. We have a long history of public service information programs in the United States that are developed and funded by government aimed at altering personal behaviors. If government advertising campaigns can be effective at increasing the prevalence of auto seat belt use or can reduce the incidence of smoking, then why couldn't a similar campaign begin to encourage more appropriate savings behavior on the part of baby boom workers? Television and radio have proven to be an extremely effective vehicle in influencing people's behavior in this country. Day in and day out, listeners are urged to buy cars, televisions, vacation cruises, beer, athletic equipment, and a wide range of other goods and services. If these media can be effective at altering ordinary consumers' behavior, then why not direct that power at the extremely important national goal of increasing savings? If the importance of personal saving was given some air time in the national media, then maybe the consumption-savings tradeoffs that workers have to make on a daily basis would become more reasonably balanced than they are today.

Another aspect of our retirement savings communications programs should be an honest description of the potential strain that future retirees are going to put on other aspects of the retirement income security system. Starting in 1995, the Social Security Administration is scheduled to begin sending out periodic statements to workers about the potential benefits they will receive from the program. Initially these statements will be targeted to workers who are over 60 years of age, but ultimately the plan is to provide annual statements to all workers over age 35. Telling people what they can expect from retirement programs while they are working is extremely desirable because it will allow them to coordinate other elements of their retirement savings in the pursuit of adequate retirement income claims. Communicating to people that they can expect benefits from Social Security in accordance with the promises embedded in current law, however, seems fraught with the danger of misleading them about the need to save through the other elements of their retirement portfolios.

ENCOURAGING EFFICIENT INVESTMENT BEHAVIOR

The shift toward a greater dependence on defined contribution plans among the employer-sponsored leg of our retirement system has included a move toward greater participant control of investment decisions over retirement assets. In part, sponsors of defined contribution plans have moved to allow participants to direct the investment of their own plan accumulations because it has allowed them to transfer much of the fiduciary responsibility for managing the assets effectively to the participants themselves. There is a growing concern, however, that participants in these plans tend to direct their assets toward overly conservative investment options that are expected to generate lower yields over time than a more balanced investment portfolio would.

There are also concerns that many participants make marginal investment decisions that follow changes in asset prices to the detriment of their long-term accumulations. The sense is that some investors tend to enter the equity markets well after a period of price increases occurs and then withdraw from the market after a downturn. Buying high and selling low is hardly an appropriate strategy for accumulating retirement assets. The problem is that many people who are being called upon to make financial investment decisions have little appreciation of how financial markets operate over time or how their investment strategies should be structured to meet their retirement income goals.

Retirement plans participants are being increasingly called upon to become retirement asset managers and additional participant education on wise investment practices would have the potential of paying significant returns. But this is also an area where some caution is in order. The potential for turning a large portion of the work force into sophisticated investment managers of their own retirement savings might be a goal that is beyond the reach of current knowledge and technology. Some sponsors of defined contribution plans that have moved toward participant directed accounts should reconsider whether this the most effective way to deliver an optimum level of retirement benefits to broad cross sections of their work forces. It may be that many of these programs would be able to deliver higher levels of retirement benefits over time at lower costs by moving back toward employer managed asset pools.

PREPARED STATEMENT OF SARAH TESLIK

This hearing is about savings. I know nothing about savings. I don't even have any. But I know a little about pensions, and pension issues are now savings issues.

Until recently, however, pension issues were not savings issues. Indeed, until recently people died before they. needed pensions. This was handy for pension policy purposes, but it is probably not something Congress can mandate, even in these days of cutbacks.

As people started to live longer, they simply received care from their younger relatives. This was a pension system, although it was not a savings system: by paying grandma's expenses during her final years, each generation paid out of current income for the pension needs of the previous generation.

This is great pension policy if two conditions are met. First, all old people need to have (a) children (b) who like them (c) who have jobs. And second, there has to be an growing population so there are enough young people to absorb the costs of the old out of their current income. If these conditions are met you don't need a savings policy.

These conditions don't exist anymore, of course. Family structures are not what they used to be. But, far more importantly, we are facing a demographic disaster

of a magnitude that virtually no one understands. Forty years ago there were 19 workers per retiree. In twenty years there will be one and a half. So our children, even if we have them, and even if they like us and work, will not have the money to support us.

So here is where savings enters the pension picture. We babyboomers need to save our own money to feed ourselves when we are old. We need to because there are too many of us for our children to support. And we need to save because unless we enhance the general health of the economy before we retire, there will simply not be enough for us to consume when we are old, regardless of whether it is our money or our children's.

This last point is a critical one. Because of the aging babyboomers, virtually the only important pension issue today is whether we as a nation are saving and investing enough as a whole. The other issues don't matter: if our economy is big and rich when the babyboomers retire, they will have the political clout to get the share of it they need, whether it is officially in pension funds or not. And if the economy is not big and healthy, it will not help retirees to be told they have the legal right to a pension for which there are insufficient assets. You can't eat pie that isn't there. So the only pension question worth addressing is really a savings question: how can we encourage savings by anyone and everyone, now, so there will be enough to go around in twenty five years? There is no easy answer. There is no easy answer because no one likes to save. This fundamental fact has one major public policy implication: it is virtually impossible for Congress to come up with any meaningful policy to encourage savings that isn't also political suicide.

This is the most critical fact in the whole savings debate: we voters do not want to save. We not only don't like to save: we like to spend And with credit cards and other debt-facilitating mechanisms we are getting better and better at spending both the money we have and the money we only hope to have. We like spending someone else's money-like future taxpayers-even better.

What this means is, it is futile and stupid to expect Congress to mandate massive new savings programs: a politician who tells his or her voters they should accept fewer services and higher taxes so we can save is not long for this world. Politicians who do the opposite—who put off paying until tomorrow for services they offer today—do well. Leaders can only be so far ahead of their troops without getting-as they used to say in Vietnam-fragged. So the national debt grows, not the national savings.

This is not meant to be an indictment of politicians. Elected politicians cannot be expected to force savings on an unwilling electorate. And we are by and large very unwilling.

So what can government do? The answer on a general level is, I think, this: politicians can only try to invent mechanisms that increase individuals' desire to save. There are lots of ways this may be possible outside of the pension area, such as taxes on consumption and favorable treatment of savings.

In the pension area, the best way to change voters minds so that they become slightly more willing to save is (a) politicians and others should try to think about how they can best convince voters that they have a serious personal crisis looming, and (b) unless they choose to save now, they will not eat when they retire. Then politicians need to direct and enhance whatever willingness to save they can create by encouraging the following three things:

(1) make individuals feel that their pension money is theirs, so they will protect it like they do their homes and bank accounts,

(2) encourage the best possible investment system for pension assets so that costs are reduced and returns are enhanced, and

(3) reduce pension costs, to limit the amount of saving needed

Note that none of these suggestions contemplates any significant government-run programs and none contemplates large new mandates to save. I think the former is unwise and the latter is politically foolish.

I will discuss three ways that I think, properly handled, have both some potential for achieving these goals and some political viability too.

PUT INDIVIDUALS IN THE PENSION PICTURE

First, we must strengthen the link between individuals and the assets that represent their pension savings. Right now, if any American worker thinks about his or her pension at all, it is usually just a vague sense that the government or an employer will write retirement checks in the future. I doubt you could find one American in a million who is covered by an employer-sponsored pension fund who could tell you how much pension money they have saved in that fund. But most everyone could tell you what is in their bank account.

You cannot expect Americans to feel an urgency to save unless they can see how much they have, think of it as theirs, and realize they need more to survive in retirement than what they have saved so far.

We must, in other words, set up pension systems in which individuals know which dollars are theirs, and know how many of them there are. Consider it: if the government tried to take money out of the average American's bank account, or tried to replace that money with government IOUs, there would be a national outcry. But there is virtually no outcry when the same things are done with Social Security funds, public pension funds, or "overfunded" corporate pension funds. We don't think of the money as ours and we don't scream. And we can't look at money that isn't ours and realize there is a massive shortfall. If we don't see the shortfall we won't want to save and no politician can fix that. But if you make us think of the money as ours, we may not only scream, we may scream without prompting from politicians, taking you off the political hot seat.

There are many interesting pension experiments going on in other countries based on systems in which each individual knows the amount of money which is his or hers. A recent World Bank report and a recent *Economist* article each summarize some of these different systems. Some of these systems require all individuals to save, some merely encourage it. Some allow the individual to select investments; others only allow them to choose between money managers. But the key common feature of these systems is that individuals can identify the money as theirs-we protect our bank accounts more than our pensions. If we could create ways to help Americans treat their pensions like their bank accounts, the biggest missing piece in the savings picture would be supplied.

TAKE EMPLOYERS OUT OF THE PENSION PICTURE

There is a link we might consider weakening at the same time. It is the link between pension funds and individual employers. This link is a historical accident, as is the link that requires employers to provide us health insurance. (We would all think it was odd if our employers bought our bed linens, yet we think it is normal for them to buy our prescriptions.) Some patterns of thought become so commonplace and traditional we forget we can rethink them.

It is important to realize that when you have, as we do, a pension system in which individual employers are expected to provide the pensions, you create a system in which the employers will, quite understandably, create a system that furthers their interests, and these interests may not be the same as the interests we have as a society more generally in fostering savings and providing meaningful pension coverage to everyone.

It is not clear to me why there is any need for the link between pensions and employers. And more importantly, it is also relatively clear to me that this link causes many problems: it is much too hard to move pensions from one employer to another, much too easy to spend one's pension assets when making such a move, much too expensive to administer a zillion little pension systems instead of one big one, much too inhibiting of meaningful competition in the management of pension assets.

Remember: when employers shoulder pension responsibility, they do so in order to retain employees-in order to prevent them from leaving. That is their main goal. They therefore, quite rightly from an employer point of view, usually tie pension benefits to years of service with the specific employer. They also-and this is the dirty little secret of the predominant form of pension plans-skew the contribution and vesting rules so that the contributions of the lower paid generally subsidize the pensions of the higher salaried workers, because the lower paid employees often don't stay long enough for any pension and are not informed enough to insist on a different arrangement.

This system creates pension and savings policy problems. The risk of losing a pension tied to an employer makes it hard for employees to move to follow new jobs in new industries. This may make it harder for the US to compete in a world in which change is both more rapid and more global. It may thus harm our saving and wealth producing capacity generally.

Pensions tied to single employers also make it hard for the poorest segments of the American workforce to collect any pension savings, because it is they who have to move from job to job most, or work only part time, and therefore are least apt to be covered by any pension savings under these systems and least able to make it up. These systems, let me repeat, are designed this way—employers wish to minimize their own costs—as they are entitled to do. But it means that the dominant motivation of the pension system is that of employers wishing to minimize savings

(contributions) and coverage, not to maximize them or extend them to the employees least apt to object.

Further, money that is spent administering pension funds is money that is not available to buy groceries and it is hard to picture a more expensive administrative system than one in which every employer, subjected to dozens of complicated statutes and hundreds of regulations, runs a mini government that takes contributions,makes investments, tracks current and former employees all over the country and sends them checks. Companies have complained loudly for years in Washington about pension administrative costs and they are said to be the main cause of the reluctance to form new defined benefit plans. These costs are inevitable in employer-based systems.

In addition, to the extent that employees are tied to a pension plan by virtue of their place of employment, they are not free to apply meaningful pressure to improve their fund's performance. In some countries, by contrast, employees may select which fund manages their money, creating real pressure on pension funds to produce good returns and minimize expenses.

Companies have other personnel practices available to them besides pension benefits to retain good employees. It may therefore be time to reassess our unquestioned assumption that employers must be the source of pensions.

REDUCE THE NEED FOR SAVINGS BY CHANGING THE PENSION PICTURE

Third, rather than—or preferably in addition to—trying to save now, you can wait until the political climate changes and try to reduce the amount of saving you need by creating wealth right when you need the money most and reducing pension expenditures at the same time. You can do this by trying to create more working Americans at the time the boomers begin to retire. Workers generate wealth. Some ways to do this are currently too politically unpopular to consider, but they may cease to be when the boomers begin to get hungry, because politicians will then have a constituency of retirees electing them. You can open the immigration gates to younger workers. You can push back retirement dates so there are more workers and fewer retirees. You can means test entitlements. No action is required on these items now.

It is a good bet that, even if some combination of these savings' enhancers is enacted, there will still be a reduction in our standard of living when the boomers retire, since it is hard to picture a democracy such as ours saving enough to meet forecasted needs. But a moderate reduction in our standard of living would certainly be preferable to the societal unrest and political instability that could result if we do not undertake, soon and seriously, some meaningful efforts to increase savings rates.

If you don't like these ideas I suggest you start having daughters to take care of you later (I realize some men do take care of their aged parents, but it is not something I would bet the ranch on) and put Spam in the basement. It keeps 20 years and is easy to save because even your friendly government tax collector doesn't want it.

PREPARED STATEMENT OF RICHARD H. THALER

Thank you Senator Bradely for this invitation to testify on the important question of the national policy towards saving. I share with you a concern about the fall in the rate of personal saving in this country, and I welcome this chance to help formulate a sensible national savings policy.

Let me say something about my background. I am Professor of Management with a Ph.D. in economics. However, I am also interested in the psychology of decision making, and my research lie's in the gap between psychology and economics in a field sometimes called *behavioral economics*. Today I will offer you a behavioral economics perspective on saving. This perspective stresses two factors normally ignored in economics discussions of savings: self-control and what I call "mental accounts." I will try to explain how these factors are important to the formulation of a national savings policy.

Problems of self-control are all too familiar to most of us, as they have been since the time of Adam and Eve. That self-control is important to saving is obvious to any parent. Piggy banks are an example of a self-control device invented to facilitate savings in young children. (I am referring to those piggy banks where it is easier to put money in than to take it out.) However, it is not just children who face self-control problems in dealing with savings. For anyone who must restrict consumption because of a limited supply of money (that is, all but the very rich) saving depends

on the ability to delay gratification. I can only put money away for later if I refrain from spending it now.

In stressing the role of self-control in understanding saving I might be accused of belaboring the obvious. However, though it may be obvious, self-control is never mentioned in traditional economic analyses of personal savings. The standard theoretical model assumes that people simply calculate how much they "should" save for retirement, and then act accordingly. The fact is that few people are capable of making the necessary calculations, and even those who can do the calculation may lack the personal resolve to stick to the rational plan.

A simple look at the data reveals how important self-control is to personal savings. Most families when they reach retirement have only three significant sources of wealth available to fund their retirement consumption: Social Security, private pensions, a paid off home. These forms of saving are often referred to as "forced saving." We can't avoid Social Security taxes, nor can we skip paying our mortgages. Like Odysseus tied to the mast, these forced saving mechanisms eliminate the need for self-control. It is a good thing that these forms of saving exist, because other forms of saving, so-called "discretionary" savings, does not amount to much. The typical household reaching retirement has less than one year's income saved in liquid assets.

The second factor I would like you to consider is the role of "mental accounts." An example will illustrate what I mean by a mental account. Some casino gamblers adopt the habit that when they win some money they put their own money in one pocket and their winnings (the "casino's money") in another pocket. These two pockets can be thought of as two "mental accounts." To understand how these matter to the study of savings it is important to realize that the theoretical agent in the standard economics model treats all assets as "fungible," that is, nearly perfect substitutes for one another. This idealized economic agent responds to a $10,000 lottery windfall in exactly the same way as to a $10,000 increase in home equity or in pension wealth.

In contrast to these theoretical actors, most real people do not treat all forms of wealth as equivalent. Instead, households allocate funds, implicitly or explicitly, into categories, or mental accounts. Some funds, e.g.,those in cash or the checking account, are designated for current consumption. Others, e.g., those in the savings account, are for "rainy days" or "special occasions." There might be subcategories here: one fund for the children's education, another for a vacation, etc.

Self-control and mental accounts come together because mental accounts vary in how "tempting" they are to invade. Money in your wallet is more tempting to spend than money in the checking account, which in turn is more tempting than the savings account. Even less tempting are funds explicitly set aside for retirement, such as money in an IRA or 401(k) plan.

Understanding the role of self-control and mental accounts is essential to formulating good policy about tax incentives forsavings. A good program must help overcome self-control problems in two ways: first, it must offer an immediate inducement to save (a sugar coated pill) to overcome the natural temptation to spend on immediate pleasures. Second, it must facilitate the preservation of savings once money has been put away. (A piggy bank does little good if the coins can easily be shaken out).

To see how we can use these concepts to help evaluate policies to increase saving, let's consider 401(k) plans. From a behavioral perspective, 401(k) plans have five attractive features. 1. The up-front tax break gives savers an immediate reward for saving. 2. When firms offer to match some or all of the employee's contribution, this immediate reward is enhanced. 3. Payroll deductions are the easiest way to save. What you don't see, you can't spend. 4. Once the payroll deductions are started, no additional action is required to keep putting new funds into the account. Inertia (often a problem in and of itself) thus *helps* keep the flow of 401(k) saving going. 5. The penalty for withdrawing funds helps reinforce the mental accounting designation of these funds as "off limits."

Notice that these arguments I have offered in support of 401(k) plans have been made on purely theoretical grounds, without use of any supporting data. On the basis of behavioral economic theory, 401(k)s look good. Of course, on the basis of standard economic theory, many economists have decided that 401(k)s look bad. Who is right? We can choose between the competing theories in two ways. One way is to do careful empirical studies to measure the impact of the program. I will share my reading of those studies with you, in a minute. Before doing that, however, I invite you to ponder the competing theoretical arguments on their own merits. Which theory do you find more plausible? If you believe that most households have no self-control problems and treat all assets as fungible, then you should be skeptical about 401(k)s, IRAs and so forth. On the other hand, if you think that most

households do find saving difficult, and are much more likely to splurge from their savings account than from their retirement account, then you have every reason to believe these plans may be highly effective.

What about the data? My own reading of the empirical studies of IRAs and 401(k)s leads me to conclude that these programs have been very successful at increasing savings, just as the behavioral analysis would predict. The most convincing evidence to my eye is the simplest. Over time, the households who contribute to IRAs and 401(k)s accumulate assets in those accounts rapidly, rarely draw down on them before retirement, and show no signs of reducing the assets in their other accounts. Furthermore, households who use these accounts display strong persistence,. Once they begin putting money into an IRA or 401(k), they tend to keep doing it.

As you know, not all economists agree with the conclusion that these tax favored programs have increased savings. Some have argued that IRAs, for example, simply shifted assets from savings accounts and other taxable savings vehicles into tax sheltered IRAs. However, these studies fail to take into consideration that money in an IRA is less likely to be spent than money in a savings account. Once this is factored in, IRAs can increase saving *even if all the money put into IRAs would have been saved anyway.* By putting funds into a less tempting account, the IRA increases long-term saving. Consider this analogy: if a child takes money from her piggy bank and buys a savings bond, has saving increased? Economists say no, just shifted. But if the piggy bank was leaky, and the bond is held to maturity, then saving has indeed increased.

The last topic I would like to discuss is the design of new savings vehicles. There is interest now in bringing back some kind of IRA. The old IRA was a good savings program from my perspective because it, like the 401(k), offered an up-front incentive to save and kept the money in a separate "off limits" account. Many of the new IRAs being proposed replace this up-front incentive with a "back-loaded" inducement. Under this plan, the tax break comes when the money is withdrawn, rather than when the money is contributed. While the two plans are equally attractive to a rational saver with no self-control problems, I doubt that anyone but an economist would predict that the plans would be equally effective at inducing savings. (Can you imagine an automobile company offering a new kind of rebate, one that the buyer receives when she sells the car, rather than when she buys it?)

If a back-loaded plan is not as good at stimulating savings, why then is it so popular on Capitol Hill? The reason has to do with another self-control problem, this one within the U.S. Congress. By back-loading the tax break, today's Congress can shift the cost of the program outside the five year budget planning window, and onto another generation of Senators and Representatives. This is seen as a way to buy increased savings today and not have to pay for it for many years. It is exactly this kind of thinking that prevents many Americans from saving, and Congress will not be setting a very good example if it falls into the same trap. While myopic accounting rules make back-loaded IRAs look deceptively good, the same rules make front-loaded IRAs look deceptively bad. When retirees start to withdraw funds from IRAs and 401(k)s they must report these redemptions as income, and tax revenues accrue. In terms of a net subsidy, these programs are not very expensive.

It is possible to do other things to increase personal savings at very low cost. Let me offer one simple proposal., Under existing law, to claim a tax deduction for an IRA a family has to have made the contribution before the tax return is filed. Why not let taxpayers designate their income tax refund to go into an IRA? We know that most taxpayers do receive refunds, and that many taxpayers intentionally overwithhold to assure this outcome (knowing that they find it hard to save in other ways). Under my proposal, a taxpayer with a $1000 refund could instruct the IRS to send the refund check directly to the financial institution where the IRA account was held. If this option were elected, the check would be increased by the taxpayer's marginal tax rate. So, if the taxpayer were in the 28% tax bracket, he could choose between a $1000 cash refund or a $1280 contribution to his IRA account. For middle class taxpayers, I think this would be a popular option, and one that is virtually costless to the government.

In conclusion, I feel that much more can be done to increase personal savings in the United States. The Congress can help by designing cost-effective savings incentives that are sensitive to the needs of the American public. However, Congress cannot help to solve America's self-control problem unless it can solve its own self-control problem.

PREPARED STATEMENT OF STEVEN F. VENTI

I thank you for the opportunity to' appear before this committee today. My name is Steven F. Venti and I am Professor of Economics at Dartmouth College and a Research Associate of the National Bureau of Economic Research. My recent research has focused on saving behavior in the United States and Canada. Much of this work, which I will review today, has been done jointly with my colleagues Professor David A. Wise of the Kennedy School of Government at Harvard University, and with Wise and Professor James Poterba of the Massachusetts Institute of Technology.

Previous hearings before this committee have documented the long-run decline in national and personal saving rates that may jeopardize both the long-term growth of the economy and the retirement security of future retirees. The piece of the problem that I will focus on is personal saving for retirement. In 1982 the typical American family on the eve of retirement had less than $7,000 of financial assets. Americans are not saving. Yet government policy can have and has in the past had a profound impact on personal saving for retirement. As I will attempt to show in my remarks today the IRA, 401(k), and similar programs can be useful tools to get families to save more for their retirement.

In the short time I have before this committee I will confine my remarks to three issues surrounding the use of these programs. The first is the distributional implications that emerge from the recent growth of these saving vehicles. The second is whether these programs actually promote new saving or instead simply displace existing saving. My final remarks will focus attention on the complex economic and psychological motives underlying the use of these accounts. I believe an understanding of why families contribute to targeted saving accounts has important implications for the design of future policies attempting to influence personal saving.

1. BACKGROUND

For nearly a decade I have been engaged in research on the saving effectiveness of what I call "targeted retirement saving programs" such as IRAs, 401(k)s, and the Keogh program. These are discretionary programs that allow individuals to save on their own behalf for the specific purpose of financing consumption in retirement. In contrast, the other principal sources of income in retirement—employer provided pensions and the government provided Social Security system—represent saving done on behalf of workers rather than by workers. One feature that distinguishes these latter programs from targeted saving accounts is that families voluntarily choose how much to save in targeted retirement saving accounts and, in most cases, have an accurate accounting of the amount saved.

The IRA and 401(k) programs are both relatively recent phenomenon. The IRA boom began in 1982 and the 401(k) trend began shortly thereafter. During the period preceeding TRA 1986 any wage earner could contribute $2,000 to an IRA. A working spouse could contribute an additional $2,000 and there was a $250 spousal IRA for nonworking spouses. All contributions were tax-deductible and the tax on funds accumulating in an IRA was deferred until withdrawal, which was permitted without penalty only after age 59 and 1/2. The Tax Reform Act of 1986 eliminated deductibility for families with employer provided pensions and incomes over certain limits.

The 401(k) program differs from the IRA in that it is employer based. Employees can only choose to participate if employers offer them a 401(k) plan. The tax advantages of a 401(k) plan are similar to those offered by an IRA. An additional advantage of a 401(k) plan is that most employers match employee 401(k) contributions, often dollar for dollar, up to some limit. The TRA 1986 did not alter the tax deductible-tax deferred status of 401(k) contributions, but it did lower the contribution ceiling from $30,000 to $7,000 in 1987 , indexed for inflation in subsequent years.

A third type of saving plan, the Keogh, is available to self-employed individuals. It's tax status is similar to the IRA, but the contribution limits are much higher. The amounts contributed to Keoghs are much less than amounts contributed to IRAs and 401(k)s and thus most of the focus of this report will be on the other two programs.

2. THE CHANGING COMPOSITION OF RETIREMENT SAVING IN THE PAST DECADE

In 1980 nearly all retirement income was accounted for by Social Security and traditional employer provided pension plans. Asset balances in non-tax advantaged financial assets were low, even on the eve of retirement. In 1982, for instance, the median level of financial assets of families age 55–64 was only about $6,600.

In the subsequent decade personal targeted retirement saving has grown dramatically as is shown in figure 1. IRA contributions rose from about $3.4 billion in 1980 to about $38 billion in both 1985 and 1986 before the big drop following the TRA of 1986. 401(k) contributions rose from zero to $50 billion by the end of the decade. Although I wouldn't want to reach any conclusions based on macro data, it is useful to point out that 401(k) contributions have trended steadily upward; there is no indication that families switched from IRAs to 401(k)s following TRA 1986. One implication is that targeted retirement saving would be higher, perhaps as much as $30 billion higher at the end of the decade, had TRA 1986 not reduced IRA contributions substantially. One puzzling feature of these data is the fall in IRA contributions between 1986 and 1987. Several analysts have pointed out that the decline is much greater that expected given that nearly 70 percent of tax filers were unaffected by the change in the law.

3. WHO USES THESE PROGRAMS?

Because these programs reduce the taxes paid on capital income they are often criticized as benefitting primarily the wealthy. Yet most contributions to both IRA and 401(k) programs are made by middle-income families. At the IRA program's peak in 1986 about 16 percent of tax filers contributed to an IRA and about 29 percent of all families with head of household under age 65 had positive IRA assets balances. (see table 1) Of course households that had low incomes or had a young household head were less likely than wealthier or older households to have an IRA. However, at the peak of the program 75% of all IRA contributions were accounted for by families with annual incomes less than $50,000. Although one may disagree on the definition of "wealthy," it is clear that a large segment of middle-income America availed themselves of these plans. IRA participation is also closely related to age. Nearly 50% of all families in the 55–65 age interval had an IRA account. Thus even though less than one-third of all families have an IRA at a single point in time, over their lifetimes at least half of all families could be expected to participate in an IRA program.

These figures suggest to me that IRA participation is far from being a tax benefit used exclusively by the wealthy—at least if judged by who uses them. Of course, all Americans benefit from saving because that's what leads to economic growth. And since most saving will ultimately be done by middle and upper income families, any programs designed to stimulate saving must impact these families if it is to have an appreciable effect on aggregate saving. In fact, the $2,000 contribution limit ensures that the wealthiest segment of the population cannot benefit disproportionately from the program. It is for this reason that the distribution of IRA assets is more equal than the distribution of other (nonIRA) financial assets in the population.

An employee can only participate in a 401(k) plan if the employer offers a plan. Although growing rapidly, only slightly more than a third of all employees were eligible for a 401(k) in 1991 (see Table 1). Currently larger and higher paying firms are more likely to offer these plans to their employees. What is particularly striking about the 401(k) experience is that if a firm offers a 401(k) program, over 60 percent of the workers choose to. participate *at all income levels.* Indeed, participation rates are essentially flat over a wide range of incomes. This pattern is in sharp contrast to the IRA experience where the overall participation rate (given universal eligibility) never exceeded 16 percent. Thus any distributional concerns regarding 401(k)s should focus on which firms offer these plans rather than on which workers choose to contribute to them. If offered, they do seem to be a successful mechanism to get even low income workers to save.

4. DO TARGETED RETIREMENT SAVING PROGRAMS INCREASE SAVING?

The more controversial question is whether funds saved in IRAs or 401(k)s are new' saving or are funds either reshuffled from existing asset balances or funds that would have been saved in the absence of these targeted retirement programs. These are difficult questions and researchers have come up with conflicting results. My work with Wise and Poterba and Wise has convinced me that these programs work. Together we have completed over a half-dozen studies, used a variety of data sources, and employed several different statistical approaches. These studies have consistently shown that targeted retirement saving programs increase saving. I cannot review all of the evidence here but I will present a few of the basic "facts" about the relationship between these programs and saving behavior that I find compelling.

To simplify the exposition I will let "other financial assets" denote financial asset saving, including stocks and bonds, but excluding IRAs and 401(k)s. We find:

- The median of other financial assets of families who had an IRA in 1984 (early in the IRA program) was only $8,600. Compare this with the typical IRA contribution of $2,300 in that year and it is clear that most IRA contributors had no history of saving anything near $2,000 per year prior to the introduction of the IRA program.
- The median of other financial assets of families who contributed to a 401(k) in 1984 (early in the 401(k) program) was only $6,515. Compare this with the typical 401(k) contribution of a little over $2,000 in that year and it is clear that most 401(k) contributors also had no history of saving anything near $2,000 per year prior to the introduction of the 401(k) program.

Both sets of comparisons above suggest that targeted retirement saving changed saving behavior. An alternative explanation is that certain families at some point in the life cycle decide to start saving. If IRAs or 401(k)s are readily available they begin saving in these forms. In this scenario funds contributed to targeted retirement saving accounts during the 1980's would have been saved in other forms in the absence of these programs. The overall increase in financial asset saving that occurred following the introduction of the IRA and 401(k) programs was a coincidence of contemporaneous events: new saving programs and families suddenly deciding to change their saving behavior. The problem with this explanation is that there is no evidence that earlier cohorts suddenly started to save a great deal at some point in their life cycles prior to 1982 when these programs became widely available.

Possibly the most convincing evidence on the saving effects comes from the experiences of different "cohorts" that were exposed to targeted retirement saving programs for different periods of time. To illustrate we consider three different cohorts: families reaching age 60–64 in 1984, families reaching age 60–64 in 1987, and families reaching age 60–64 in 1991. The choice of years is determined by the availability of data from the Survey of Income and Program Participation. The oldest cohort—those age 60–64 in 1984—had fewer years to have their saving behavior affected by targeted retirement saving programs than the youngest cohort. The tabulation below presents median asset balances for the three cohorts. All figures are in 1991 dollars and statistically control for differences in income and demographic characteristics. The category targeted retirement saving includes IRAs, 401(k)s and Keogh contributions.

	Reaching age 60–64 in—		
	1984	1987	1991
% with Targeted Retirement Saving	38	41	42
Approx Years of Exposure to Plans	2	5	9
Targeted Retirement Assets	7,575	13,119	21,613
Other Financial Assets	19,358	18,157	17,950
Total Financial Assets	29,847	34,013	45,019
% without Targeted Retirement Saving	62	59	58
Total Financial Assets	2,247	1,982	1,691

The growth in IRA and 401(k) asset balances is astounding. The typical member of the youngest cohort—with the nine years of exposure to targeted retirement saving programs—has nearly three times the targeted retirement assets of the oldest cohort. There is a comparable increase in total assets as well. Note also that among families without these programs other financial assets fell by a lot. Thus there is little evidence that younger cohorts are saving less in other assets despite saving considerable more in targeted retirement saving assets. The net result is that total financial assets, including balances in IRAs and 401(k)s, are much larger for the younger cohort in 1991 than for the older cohort in 1984, thus suggesting that targeted retirement saving programs did stimulate new saving over the period. Results for other cohorts reveal similar results.

5. WHAT HAVE WE LEARNED FROM THE IRA–401(K) EXPERIENCE?

After spending nearly a decade looking at these programs, one of the things most evident to me is that any evaluation of saving incentive plans must consider more than the simple financial incentives offered by these plans. This may be a bit of heresy among public finance economists, but the IRA and 401(k) "programs" are more than simple tax breaks. appealing to the financial instincts of investors. The traditional approach to evaluation of these programs assumes saving in targeted retirement savings programs and saving in conventional non-tax advantaged forms are

close substitutes. In this simple framework the tax deductibility and tax deferral features of these programs make them financially superior to conventional saving vehicles. Following this line of reasoning, most investors "should" substitute IRAs and 401(k) saving for other forms of saving. Indeed, many critics of the program have used this theoretical framework to assert that IRAs and 401(k)s cannot increase saving.

Our recent experience with targeted retirement saving programs suggests this conventional view is too simple and ignores a host of real world psychological, behavioral, and economic factors that in many cases may dominate simple financial considerations. The way these programs are marketed and promoted, the ease with which accounts can be opened or set up, and the complex behavioral response to features such as the up-front deduction and the withdrawal penalty must all be acknowledged. Some examples are presented below to demonstrate that savings choices are more than narrow financial decisions and to suggest more broadly some alternative factors involved in the saving decision. Unfortunately, unlike simple models' of financial optimization, there are no simple models of the complex behavior that motivates the use of the targeted retirement saving programs.

One of the clearest indications that something other than simple financial considerations matter is provided by IRA contributor response to the Tax Reform Act of 1986. Families that lost the full tax-deductibility of IRA contributions in 1987 are still able to make after-tax contributions to IRAs. These nondeductible IRAs financially dominate conventional saving instruments, yet investors have shown little interest in them. Thus it is apparent that the up-front deduction is an important feature—the tax deferral alone is not enough to offset the reluctance of most families to save for retirement. This may suggest that "backloaded IRAs" which accept after-tax contributions but allow tax-free withdrawals may also escape the attention of investors, despite the financial equivalence between front-loaded and back-loaded schemes. The recent experience with the PEP program in the UK also suggests that the up-front deduction may be an essential ingredient.

IRA participation by families retaining full tax-deductibility fell by, on average, over 40 percent between 1986 and 1987. From a purely financial view a reduction of this magnitude is puzzling. For some there may have been a small reduction in marginal tax rates, but the overwhelming financial advantage of IRAs over non-tax advantaged saving instruments remained intact. There is no financial basis for this reduction. Clearly other forces were at work, most likely reduced levels of promotion by financial institutions and/or the misreporting of TRA 1986 in the media.

Promotion and marketing may also play a key role is the bunching of IRA contributions near the April 15 tax deadline. Again, such behavior is not financially optimal: investors should contribute to an IRA as early as possible in the tax year to maximize the advantage of tax free accumulation of interest. Several nonfinancial factors probably contribute to this bunching. First, financial institutions promoted IRAs more heavily during the tax filing season, perhaps inducing customers to buy a product they otherwise would not have purchased. Second, Dan Feenberg and Jon Skinner show that families with a positive tax liability (revealed at the tax filing deadline) are more likely to contribute to an IRA that are persons due a refund, all other factors held constant. Taxpayers apparently get some satisfaction paying the broker rather than the IRS. Finally, the "now or never" choice imposed by the April 15th deadline may get some procrastinating families to do what they would have put off indefinitely. Psychological rather than financial factors seem to play an important role in these instances.

Another feature of both IRA and 401(k) programs is the early withdrawal penalty that effectively "locks up" most contributions until retirement. The presence of this penalty has several effects, some psychological and some economic. The most obvious economic effect is that it differentiates retirement saving from other saving that may be used for pre-retirement expenditures. This distinction has been used by many to explain why families hold both tax advantaged and non-tax advantaged assets when the former have a higher return. This distinction (reinforced by the marketing of these accounts as retirement vehicles) also has psychological implications. The relative illiquidity of these accounts may be a self-control device desired by some savers. The accounts represent a way of placing some part of saving "off limits" as emphasized by Thaler in his "mental accounting" explanation of such behavior. If this is the case, then just getting a family to transfer one dollar from a conventional account to a retirement account may, in the long-run increase saving.

Finally, I've always been puzzled by the high participation rates in 401(k) plans, especially given our experience with IRA plan. Given eligibility, participation is about 16 percent in the IRAs and about 70 percent in 401(k)s. What accounts for this difference? One explanation is that 401(k)s are often financially more attractive due to employer matching. Yet since both programs so clearly dominate conven-

tional saving this can hardly be the complete explanation. Other features of the 401(k) plan may also be relevant. One is that contributions are made by automatic payroll deduction which may better enable employees to commit to a long-term saving strategy. Once the decision to enroll is made further saving decisions need not be made on a regular basis. Another explanation may be the employer and peer employee pressure to participate in a 401(k), a factor not at work in the IRA program. Such pressure may serve two roles, both to inform workers that it is the financially prudent thing to do, and to directly promote the program to workers. In either case it seems clear that accessibility, information, and promotion can have significant effects on the decision to participate in these plans.

6. SUMMARY

Previous hearings before this Committee have established that low rates of saving threaten the financial security of future generations of retirees. Despite this uncertain future, most Americans are nearing retirement with strikingly little in the form of financial assets to fall back upon. In 1982, for example, the typical American family only had less than $7,000 of financial assets to rely on in retirement.

In part to address this problem the U.S. has adopted recent programs such as the IRA and 401(k) to encourage individuals to save for their own for retirement. I believe the weight of the evidence shows that these targeted retirement saving programs do increase saving. The data clearly show that most families that contribute to these plans were not saving at this level before their advent and that longer exposure to these plans results in higher levels of retirement saving.

Finally, our recent experience with the IRA and 401(k) programs suggests that saving is as much a psychological as an economic decision, and any analysis of proposals to encourage saving should address both these dimensions.

Figure 1 401(k) & IRA Contributions
In Billions, 1980 to 1990

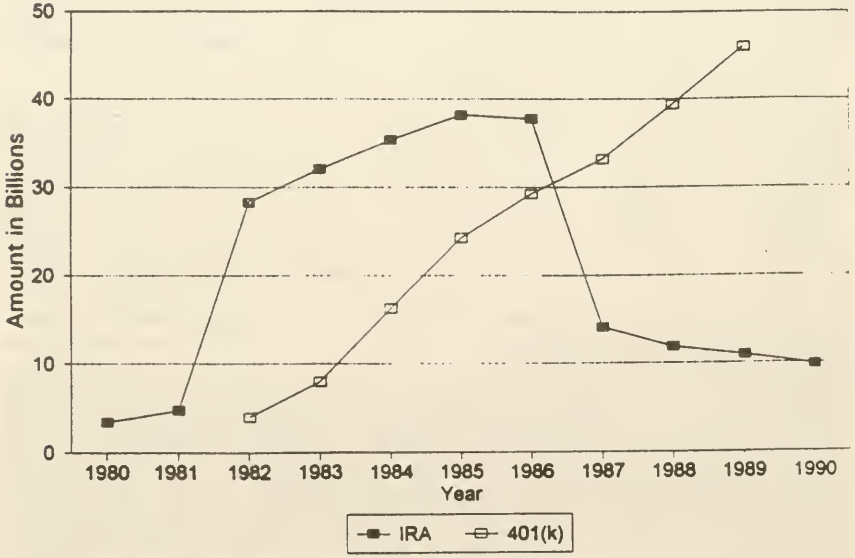

Table 1. IRA and 401(k) Use by Income

Income Interval	% having IRA (1)	401(k) % eligible (2)	401(k) % particip if eligible (3)	401(k) % particip (4)
less than $10,000	8.3	6.4	70.8	4.5
10-20,000	12.3	16.6	63.0	10.5
20-30,000	22.7	29.7	61.7	18.4
30-40,000	31.9	39.0	67.3	26.2
40-50,000	41.1	43.7	72.9	31.8
50-75,000	56.1	53.8	73.3	39.4
greater than $75,000	66.6	48.1	85.8	41.3
all	28.8	34.7	70.8	24.6

all data are for 1991 except column (1) is 1987.
source: All SIPP households with at least one member employed and neither member self-employed.

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